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IMPACT OF TAX SIMPLIFICATION ON THE U.S. ECONOMY

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

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TAX POLICY AS INDUSTRIAL POLICY

WEDNESDAY, MARCH 13, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce and Shumway.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

Today will be the first day in a series of hearings the Subcommittee on Economic Stabilization will hold on the implications of the Treasury Department's tax simplification proposal.

Since the Treasury plan was unveiled in December, there has been much debate and controversy over the effect the proposal would have on specific sectors of our economy.

Concern has been raised that the plan would unduly penalize some sectors, such as manufacturing and real estate, while rewarding others such as trade and service industries.

In addition, there has been concern that the plan would depress overall levels of investment, lower productivity, and curtail economic growth.

The purpose of today's hearing is to provide an overview of the impact of the Treasury proposal on the various sectors of our economy, as well as inquire into the consequences of the plan for overall economic growth and international competitiveness.

We are fortunate to have with us this morning to address these issues three acknowledged experts in this field: Prof. Don Fullerton of the University of Virginia; Mr. Nariman Behravesh of Wharton Econometrics; and Prof. Alan J. Auerbach of the University of Pennsylvania.

Subsequent hearings of this subcommittee will examine the impact of the Treasury tax simplification plan on, at the least, the manufacturing, real estate, finance, and insurance industries, as well as compare the corporate tax codes of our major trading partners to our own as promoters of industrial competitiveness.

What becomes apparent from even a brief summary of the hearings this subcommittee plans to hold on the sectoral consequences of the Treasury tax proposal is the massive industrial policy the Federal Government presently runs through the tax system.

The congressional Joint Committee on Taxation estimates that in 1985 the Federal Government will provide approximately $95 billion of subsidies to industry through the corporate tax code.

Whether activity-specific or industry-specific, corporate tax subsidies have played—and continue to play—a profound role in shaping the structure and international competitiveness of our economy. Some of these incentives have undoubtedly proven useful and have helped our industries to compete in the international marketplace; but many other tax incentives are wasteful, inefficient, and unaccountable.

We would be better off, in my view, shifting from our heavy reliance on the Tax Code to a system of government support which would be more flexible, accountable, and more conditional.

Let us now begin today by examining the effectiveness of our current tax-based industrial policy and the sectoral consequences of the Treasury's tax simplification proposal.

Our first witness will be Mr. Nariman Behravesh, as I said, vice president of U.S. Services, Wharton Econometric Forecasting Associates of Philadelphia, PA. Mr. Behravesh, I think, basically directed the study by Wharton Econometrics of the tax simplification plan.

We will follow that up with Professor Fullerton of the University of Virginia. It is my understanding that Professor Fullerton coauthored the American Enterprise Institute's study released approximtely a week ago, which reached some dramatic conclusions about the impact of the Treasury tax plan.

Mr. Auerbach, professor of economics at the University of Pennsylvania, will be the concluding witness. He is from Philadelphia, PA.

In any event, let us begin. Our first witness will be Mr. Behravesh.

STATEMENT OF NARIMAN BEHRAVESH, VICE PRESIDENT OF U.S. SERVICES, WHARTON ECONOMETRIC FORECASTING ASSOCIATES

Mr. BEHRAVESH. Thank you, Mr. Chairman.

I am pleased to appear before this subcommittee to discuss the views of Wharton Econometrics regarding the economic impact of the Treasury's tax reform proposals.

The Treasury tax reform plan proposed many far-reaching changes in the taxation of business and investment income.

The most important changes include: Substitution of real economic depreciation for the accelerated cost recovery system [ACRS] and the investment tax credit; repeal of the preferential provisions for financial institutions and the energy and mining industries; a new deduction for half of dividends paid by corporations; adjustment of interest income and capital gains for inflation; and reduction of individual and corporation income tax rates.

The purpose of these changes is to restore the neutrality of the tax system as it applies to different assets and industries, and to improve the allocation of capital in the economy.

By its very nature, the Treasury plan to introduce real economic depreciation as a basis for calculating net business income would raise the cost of capital for some assets and industries, and lower it for others.

ACRS, the investment tax credit, and the interest deduction reduce the effective tax rates on some assets much more than on others—in some cases, they result in a negative tax, or subsidy.

Reduction of these large differences in tax rates would reduce the influence of tax considerations on business and investment decisions, and would thus improve the allocation of resources.

In general, the cost of capital would rise for producers' durable equipment—particularly long-lived equipment, which receives very favorable treatment under ACRS—and it would also rise, that is, the cost of capital would also rise, for highly leveraged structures.

Corporation tax liabilities would increase by an average of about 25 percent over the long run.

The basic corporate tax provisions applying to business investment, including the revised depreciation proposal, the repeal of the investment credit, and the new dividend deduction, would raise about as much revenue as the cut in the corporate rate would reduce revenues. The increase in the corporate tax would come entirely from the elimination of tax preferences and tax shelters.

In effect, the tax reduction of about 8 percent for individual taxpayers is financed by eliminating those provisions that have had the most distorting effect on the economy.

The Treasury plan, which would virtually eliminate tax shelters, would raise the cost of capital for rental housing and commercial building. Owner-occupied housing would retain its relative tax advantage, but the cost of this housing would also rise somewhat because the deduction for property taxes would be eliminated and the cut in tax rates would reduce the tax value of the interest deduction of home mortgages.

However, owner-occupied housing would become even more attractive, in a relative sense, to rental housing than it is under present law.

Indexation of interest receipts and expenses would raise the rate of return of lenders and increase the cost of borrowing, thus increasing the supply of loans and reducing the demand for them.

These two effects work in the same direction; that is, to reduce interest rates. It is very difficult to predict how much interest rates would decline. Increasingly, U.S. interest rates are set in world markets, and changes in U.S. tax laws may have only a limited impact on domestic interest rates.

Given this uncertainty about the course of interest rates under the Treasury plan, Wharton Econometrics has considered two scenarios. In the first, interest rates remain largely unchanged; that is, relative to a current baseline. In the second, interest rates fall by about 150 basis points.

The impact of the Treasury plan on investment depends largely on the assumed path of interest rates. If interest rates decline, then the overall level of investment will be unchanged; that is, investment in some industries would be lower than in a current-policy baseline but higher in other industries.

The rise in the cost of capital due to the enactment of the Treasury plan would be offset by the drop in interest rates for many industries.

If, on the other hand, interest rates remain unchanged, then aggregate investment is lower than in the current-policy baseline, with most industries seeing some rise in their cost of capital. The impact on some industries would be large; however, the effect on the aggregate investment would not be large.

In both scenarios, the macroeconomic impact of the Treasury plan is quite small. Based on this analysis, Wharton Econometrics concludes that, at worst, the Treasury tax plan would have a small negative impact on overall investment; and, at best, it would leave aggregate investment unchanged.

Therefore, the plan can be viewed as being neither antigrowth nor progrowth. Instead, it addresses some of the distributional imbalances of the current Tax Code.

Stepping back a little bit, I would like to review some of what I have said in a little bit more detail.

Economists have developed the concept of the cost of capital to analyze the effect of taxation on investment incentives. The cost of capital can be defined as the before-tax rate of return a particular investment must yield to cover the after-tax cost of funds to the firm. If the cost of capital increases, business investment is discouraged; if it declines, investment is encouraged.

The cost of capital can be estimated for particular assets and industries as well as for the business sector as a whole.

Table 1 in my testimony shows how the costs of capital for the major industrial sectors of the United States have changed in the past decade.

Clearly, increases or reductions in taxes, through changes in capital consumption allowances, special preferences, or reductions in tax rates, can have significant effects on the cost of capital and hence on investment decisions.

Tables 2 through 4 in my testimony show how the various corporate tax measures that affect the cost of capital have changed in the past 10 years.

In analyzing the impact of the Treasury plan on the cost of capital, Wharton Econometrics considered only the major provisions of the plan.

Accordingly, the removal of investment tax credit raises the cost of capital.

The modification of ACRS, by lengthening tax lives, also raises the cost of capital.

The reduction in the statutory corporate profits tax rate lowers the cost of capital.

The partial deductibility of dividend payments lowers the effective corporate profits tax rate and, therefore, lowers the cost of capital.

The removal of tax preferences for the energy, financial and construction industries raises the effective corporate profits tax rate and the cost of capital in those particular industries.

The other, smaller provisions of the Treasury plan affect the cost of capital only to the extent that they raise or lower the effective corporate profits tax rate.

The Treasury plan would reduce the cost of capital for investment in structures and would increase it for equipment. This would occur because, under present law, the investment tax credit is given only for equipment purchases. Removal of the credit and reduction of the corporate tax rate would thus be favorable for structures.

While total corporate tax liabilities would increase under the Treasury plan, on average, the estimate changes in the cost of capital would be small because the repeal of the investment tax credit and the revisions of the depreciation allowances would roughly equal the cost of the new dividend deduction and reduction in the corporate tax rate. The increase in corporate taxes would be concentrated in three sectors—energy, financial and construction—which would lose the tax advantages they now receive.

Changes in interest rates also have a big impact on the cost of capital. One of the major sources of uncertainty regarding the impact of the Treasury plan is the impact of the provision to index the tax treatment of interest income and costs.

Such indexing would remove the tax burden on the inflation component of interest rates. Theoretically, this would lead to lower market rates. This offset would be reinforced by lower marginal tax rates on interest income. There are two qualifications to this theoretical result, however.

First, in the past, nominal interest rates have not fully reflected the effect of inflation. Consequently, if the tax penalty on interest due to inflation is removed, the decline in nominal interest rates might not fully reflect the theoretical reduction in the tax penalty.

Second is the extent to which U.S. rates are determined in international markets.

Since foreigners do not pay U.S. taxes and capital flows freely across national borders in the search for the most attractive returns, nominal interest rates in the United States might decline only slightly. This would occur because the exchange rate of the dollar would fall as interest rates fell, capital inflows into the United States would slow down, and the decline in interest rates would be arrested or possibly even reversed.

Because of this uncertainty over the impact of the Treasury plan on interest rates, Wharton Econometrics has considered two scenarios. The first assumes that interest rates are unchanged from the current-policy baseline; the second assumes that interest rates fall roughly 150 basis points. The impact of each of these scenarios on the cost of capital, on investment, and on housing is quite different.

The effect on the cost of capital is shown in table 1. In the first scenario, the cost of capital rises for all industries. In the second scenario, the cost of capital is higher only for some industries.

Looking now to investments, in the scenario where interest rates do not change from the current-policy baseline, the combined impact of the Treasury's corporate tax reform proposals slows investment growth.

By 1994, nonresidential fixed investment is roughly 3 percent below the current-policy baseline. Investment in all the major industrial sectors is either unchanged or down a little bit.

In the lower-interest-rate scenario, the Treasury tax plan has almost no impact on investment. The rise in the cost of capital due to the Treasury proposals is offset by the drop in interest rates.

By 1994, investment is only 0.3 percent below the current-policy baseline, which is really insignificant. Investment in the major industrial sectors is largely unchanged. Lower investment in some industries is offset by higher investment in others.

Looking next at construction, in the scenario where interest rates are unchanged, the cost of homeownership increases. The increase would likely be small at the lower income levels, but it would rise considerably for households with higher incomes.

The rise reflects the effect of the proposed reduction in the marginal tax rate—which would reduce the tax value of the interest deduction.

Also, it reflects the elimination of the deduction for property taxes, and mortgage interest payments for second homes. On the other hand, if the mortgage rate declined, the cost of homeownership would decline on average.

The proposed revisions would have a more dramatic impact on the cost of rental housing. If the mortgage rate was unchanged, the cost of rental housing would rise by some 50 percent. If the mortgage rate declined, the increase in the cost of rental housing would be cut by half. The increases are the result mainly of the reduced mortgage interest deduction under the Treasury's indexation scheme.

The cost of commercial structures would also rise, but by somewhat less than the cost of rental housing. The smaller rise in the cost of commercial than of residential structures reflects the fact that, typically, straight line depreciation is used in the former—that is, commercial, and ACRS in the latter, that is, rental housing—so that the change to real economic depreciation has a much larger effect on residential structures.

Construction of rental housing and commercial structures would decline if the Treasury plan were enacted. But owner-occupied housing would become much more attractive, and the ratio of owner-occupied housing units to rental units would rise.

Clearly, the virtual elimination of tax shelter possibilities would have a major effect on the construction sector.

Finally, looking at the macroeconomic impacts, in both scenarios, the impact of the Treasury plan on real growth and inflation is very small. In both cases, real GNP rises in the first 5 years as consumption growth—boosted by the cut in personal tax rates—more than offsets any slowdown in investment.

However, by 1994, the level of real GNP in the two scenarios is almost identical to the level of GNP in the current-policy baseline. In this sense, it can be said that the Treasury plan is neither antigrowth nor progrowth.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Behravesh on behalf of Wharton Econometrics follows:]

STATEMENT OF NARIMAN BEHRAVESH

Summary and Introduction

Mr. Chairman, I am pleased to appear before this subcommittee to discuss the views of Wharton Econometrics regarding the economic impact of the Treasury's tax reform proposals.

The Treasury tax reform plan proposes many far-reaching changes in the taxation of business and investment income. The most important changes include: substitution of real economic depreciation for the accelerated cost recovery system (ACRS) and the investment tax credit; repeal of the preferential provisions for financial institutions and the energy and mining industries; a new deduction for half of dividends paid by corporations; adjustment of interest income and capital gains for inflation; and reduction of individual and corporation income tax rates.

The purpose of these changes is to restore the neutrality of the tax system as it applies to different assets and industries, and to improve the allocation of capital in the economy.

By its very nature, the Treasury plan to introduce real economic depreciation as a basis for calculating net business income would raise the cost of capital for some assets and industries and lower it for others. ACRS, the investment tax credit, and the interest deduction reduce the effective tax rates on some assets much more than on others (in some cases, they result in a negative tax, or subsidy). Reduction of these large differences in tax rates would reduce the influence of tax considerations on business and investment decisions, and would thus improve the allocation of resources. In general, the cost of capital would rise for producers' durable equipment—particularly long-lived equipment, which receives very favorable treatment under ACRS—and highly leveraged structures.

Corporation tax liabilities would increase by an average of about 25% over the long run. The basic corporate tax provisions applying to business investment, including the revised depreciation proposal, the repeal of the investment credit, and the new dividend deduction, would raise about as much revenue as the cut in the corporate rate would reduce revenues. The increase in the corporate tax would come primarily from the elimination of tax preferences and tax shelters. In effect, the tax reduction of about 8%

for individual taxpayers is largely financed by eliminating those provisions that have had the most distorting effect on the economy.

The Treasury plan, which would virtually eliminate tax shelters, would raise the cost of capital for rental housing and commercial building. Owner-occupied housing would retain its relative tax advantage, but the cost of this housing would also rise somewhat because the deduction for property taxes would be eliminated and the cut in tax rates would reduce the tax value of the interest deduction of home mortgages. However, owner-occupied housing would become even more attractive relative to rental housing than it is under present law.

Indexation of interest receipts and expenses would raise the rate of return of lenders and increase the cost of borrowing, thus increasing the supply of loans and reducing the demand for them. The two effects work in the same direction—that is, to reduce interest rates. It is very difficult to predict how much interest rates would decline. Increasingly, U.S. interest rates are set in world markets, and changes in U.S. tax laws may have only a limited impact on domestic interest rates. Given this uncertainty about the course of interest rates under the Treasury plan, Wharton Econometrics has considered two scenarios. In the first, interest rates remain largely unchanged. In the second, interest rates fall by about 150 basis points.

The impact of the Treasury plan on investment depends largely on the assumed path of interest rates. If interest rates decline, then the overall level of investment will be unchanged. Investment in some industries would be lower than in a current-policy baseline but higher in other industries. The rise in the cost of capital due to the enactment of the Treasury plan would be offset by the drop in interest rates for many industries. If, on the other hand, interest rates remain the same, then aggregate investment is lower than in the current-policy baseline, with most industries seeing some rise in their cost of capital. The impact on some industries would be large; however, the effect on aggregate investment would not be large.

In both scenarios, the macroeconomic impact of the Treasury plan is quite small. Based on this analysis, Wharton Econometrics concludes that at worst the Treasury tax plan would have a small negative impact on overall investment, and at best it would leave aggregate investment unchanged. Therefore, the plan can be viewed as being neither anti-growth nor pro-growth. Instead, it addresses some of the distributional imbalances of the current tax code.

Cost of Capital

Economists have developed the concept of the cost of capital to analyze the effect of taxation on investment incentives. The cost of capital is the before-tax rate of return a particular investment must yield to cover the after-tax cost of funds to the firm. If the cost of capital increases, business investment is discouraged; if it declines, investment is encouraged. The cost of capital can be estimated for particular assets and industries as well as for the business sector as a whole. Table 1 shows how the costs of capital for the major industrial sectors of the United States have changed in the past decade. Clearly, increases or reductions in taxes, through changes in capital consumption allowances, special preferences, or reductions in tax rates, can have significant effects on the cost of capital and hence on investment decisions. Tables 2 through 4 show how the various corporate tax measures that affect the cost of capital have changed in the past 10 years.

In analyzing the impact of the Treasury plan on the cost of capital, Wharton Econometrics considered only the major provisions of the plan. Accordingly,

- The removal of the investment tax credit raises the cost of capital.
- The modification of ACRS, by lengthening tax lives, raises the cost of capital.
- The reduction in the statutory corporate profits tax rate lowers the cost of capital.
- The partial deductibility of dividend payments lowers the effective corporate profits tax rate and, therefore, lowers the cost of capital.

- The removal of tax preferences for the energy, financial, and construction industries raises the effective corporate profits tax rate and the cost of capital in those industries.

- The other, smaller provisions of the Treasury plan affect the cost of capital only to the extent that they raise or lower the effective corporate profits tax rate.

The Treasury plan would reduce the cost of capital for investment in structures and would increase it for equipment. This would occur because under present law the investment tax credit is given only for equipment purchases. Removal of the credit and reduction of the corporate tax rate would thus be favorable to structures.

While total corporate tax liabilities would increase under the Treasury plan, on average the estimated changes in the cost of capital would be small because the repeal of the investment tax credit and the revision of the depreciation allowances would roughly equal the cost of the new dividend deduction and the reduction in the corporate tax rate. The increase in corporate taxes would be concentrated in three sectors—energy, financial, and construction—which would lose the tax advantages they now receive.

Interest Rates

Changes in interest rates also have a big impact on the cost of capital. One of the major sources of uncertainty regarding the impact of the Treasury plan is the impact of the provision to index the tax treatment of interest income and costs. Such indexing would remove the tax burden on the inflation component of interest rates. Theoretically, this would lead to lower market rates. This offset would be reinforced by lower marginal tax rates on interest income.

There are two qualifications to this theoretical result, however. First, in the past, nominal interest rates have not fully reflected the effect of inflation. Consequently, if the tax penalty on interest due to inflation is removed, the decline in nominal interest rates might not fully reflect the theoretical reduction in the tax penalty.

Second is the extent to which U.S. rates are determined in international markets. Since foreigners do not pay U.S. taxes and capital flows freely across national borders in the search for the most attractive returns, nominal interest rates in the United States might decline only slightly. This would occur because the exchange rate of the dollar would fall, capital inflows into the United States would slow down, and the decline in interest rates would be arrested or even reversed.

Because of this uncertainty over the impact of the Treasury plan on interest rates, Wharton Econometrics has considered two scenarios:

- The first assumes that interest rates are unchanged from the current-policy baseline.

- The second assumes that interest rates fall roughly 150 basis points from the current-policy baseline.

The impact of each of these scenarios on the cost of capital, on investment, and on housing is different. The effect on the cost of capital is shown in Table 1. In the first scenario, the cost of capital rises for all industries. In the second scenario, the cost of capital is higher for only some industries.

Investment

In the scenario where interest rates do not change from the current-policy baseline, the combined impact of the Treasury's corporate tax reform proposals slows investment growth.

- By 1994 nonresidential fixed investment is roughly 3% below the current-policy baseline.

- Investment in all the major industrial sectors is either unchanged or down a little.

In the lower-interest-rate scenario, the Treasury tax plan has almost no impact on investment. The rise in the cost of capital due to the Treasury proposals is offset by the drop in interest rates.

- o By 1994 investment is 0.3% below the current-policy baseline.
- o Investment in the major industrial sectors is largely unchanged. Lower investment in some industries is offset by higher investment in others.

Construction

In the scenario where interest rates are unchanged, the cost of homeownership increases. The increase would likely be small at the lower income levels, but it would rise considerably for households with high incomes. The rise reflects the effect of the proposed reduction in the marginal tax rate (which would reduce the tax value of the interest deduction) and the elimination of the deduction for property taxes and mortgage interest payments for second homes. On the other hand, if the mortgage rate declined, the cost of homeownership would decline on average (see Table 1).

The proposed revisions would have a more dramatic effect on the cost of rental housing. If the mortgage rate was unchanged, the cost of rental housing would rise by roughly 50% (see Table 1). If the mortgage rate declined, the increase in the cost of rental housing would be reduced. The increases are the result mainly of the reduced mortgage interest deduction under the Treasury's indexation scheme.

The cost of commercial structures would also rise, but by somewhat less than the cost of rental housing. The smaller rise in the cost of commercial than of residential structures reflects the fact that, typically, straight-line depreciation is used in the former and ACRS in the latter, so that the change to real economic depreciation has a much larger effect on residential structures.

Construction of rental housing and commercial structures would decline if the Treasury plan were enacted. But owner-occupied housing would become much more attractive, and the ratio of owner-occupied housing units to rental units would rise.

Clearly, the virtual elimination of tax shelter possibilities would have a major effect on the construction sector.

Macroeconomic Impacts

In both scenarios, the impact of the Treasury plan on real growth and inflation is very small. In both cases real GNP rises in the first five years as consumption growth (boosted by the cut in personal tax rates) more than offsets any slowdown in investment. However, by 1994 the level of real GNP in the two scenarios is almost identical to the level of GNP in the current-policy baseline. In this sense, it can be said that the Treasury plan is neither anti-growth nor pro-growth.

Table 1: User Cost of Capital (%)

				Baseline	Treasury Alternative	
					Scenario 1	Scenario 2
	1975	1980	1985	1990	1990	1990
Farm	33.8	56.4	60.6	72.6	84.1	79.3
Mining	32.5	52.3	52.9	63.3	70.2	65.2
Durable Goods						
Lumber	19.7	34.8	36.6	43.7	51.2	46.8
Furniture	26.5	46.5	46.4	55.4	62.1	57.4
Stone, Clay and Glass	21.3	39.6	39.2	46.6	52.8	48.2
Primary Metals	26.4	44.8	45.3	54.1	62.0	57.3
Fabricated Metal Product	21.4	37.3	37.8	45.1	52.7	48.1
Nonelectrical Machinery	22.3	39.2	38.7	46.1	51.8	47.3
Electrical Machinery	21.7	37.9	38.9	46.3	52.6	48.0
Motor Vehicles	27.3	46.4	46.0	55.0	63.8	59.2
Nonauto Transp Eq & Misc Manu	32.4	53.9	53.4	63.9	74.4	69.2
Instruments	23.0	39.2	39.1	46.6	53.2	48.6
Nondurable Goods						
Food and Beverages	26.8	45.4	45.5	54.4	61.9	57.2
Tobacco	27.2	46.4	48.6	58.1	62.0	57.3
Textiles	26.3	44.3	44.5	53.1	62.2	57.5
Apparel	29.1	48.5	49.3	59.0	68.3	63.6
Paper	21.4	37.2	37.8	45.0	53.5	48.9
Printing and Publishing	25.8	42.7	43.6	52.1	62.9	58.2
Chemicals	26.0	44.7	44.0	52.6	63.3	58.5
Petroleum	23.9	40.2	41.1	48.9	54.7	50.0
Rubber	20.2	35.9	35.8	42.6	50.3	45.7
Leather	21.5	37.0	38.7	46.1	53.7	49.0
Transportation	27.3	45.0	46.4	58.3	64.6	59.7
Commercial	24.6	41.9	44.2	52.6	60.3	55.7
Utilities	25.2	45.9	47.0	53.5	54.1	49.3
Communications	27.3	47.5	48.0	54.9	59.4	54.5
Total Resid Housing Units	12.8	23.7	22.4	30.8	35.3	32.6
Owner Occupied	12.5	24.8	23.6	32.0	34.1	31.3
Landlord Owned	10.4	19.3	18.5	24.9	36.0	33.3
Mobile Homes	16.9	28.1	26.7	37.1	39.1	36.7

Table 2: Corporate Tax Rates (%)

				Baseline	Treasury Alternative (Scenarios 1 & 2)
	1975	1980	1985	1990	1990
All Industries	34.5	34.3	32.1	32.0	31.1
Farm	23.8	27.8	26.2	26.2	31.1
Mining	46.9	41.5	39.0	39.0	31.1
Durable Goods					
Lumber	33.2	35.4	33.3	33.3	31.1
Furniture	39.7	41.0	38.6	38.6	31.1
Stone, Clay and Glass	41.4	46.9	44.0	44.0	31.1
Primary Metals	41.6	42.2	39.7	39.7	31.1
Fabricated Metal Products	42.3	41.8	39.3	39.3	31.1
Nonelectrical Machinery	44.9	44.5	41.8	41.8	31.1
Electrical Machinery	43.3	42.8	40.2	40.2	31.1
Motor Vehicles	47.2	44.4	41.7	41.7	31.1
Nonauto Transp Eq & Misc Manu	41.2	42.3	39.8	39.8	31.1
Instruments	45.2	43.8	41.2	41.2	31.1
Nondurable Goods					
Food and Beverages	44.6	43.3	40.7	40.7	31.1
Tobacco	46.7	41.6	39.1	39.1	31.1
Textiles	[illegible]	41.9	39.4	39.4	31.1
Apparel	38.5	41.2	38.7	38.7	31.1
Paper	42.7	42.6	40.1	40.1	31.1
Printing and Publishing	41.7	37.4	35.2	35.2	31.1
Chemicals	45.8	44.7	42.1	42.1	31.1
Petroleum	43.5	43.5	40.9	40.9	31.1
Rubber	42.2	41.1	38.6	38.6	31.1
Leather	40.3	38.9	36.6	36.6	31.1
Transportation	37.6	40.3	37.9	37.9	31.1
Utilities	43.2	44.5	41.8	41.8	31.1
Communications	45.9	45.7	43.0	43.0	31.1
Commercial	29.4	29.0	27.2	27.2	31.1

Table 3: Investment Tax Credit Rates (%)

	1975	1980	1985	Baseline 1990	Treasury Alternative (Scenarios 1 & 2) 1990
Average, All Industries	5.3	6.1	6.1	6.3	0.0
Farm	4.9	4.4	4.6	4.6	0.0
Mining	5.6	5.7	5.9	5.9	0.0
Durable Goods					
Lumber	7.2	8.2	8.2	8.2	0.0
Furniture	5.8	5.9	6.4	6.4	0.0
Stone, Clay and Glass	7.4	8.2	8.4	8.4	0.0
Primary Metals	7.0	8.1	8.2	8.2	0.0
Fabricated Metal Product	7.1	7.6	7.8	7.8	0.0
Nonelectrical Machinery	6.5	7.2	7.6	7.6	0.0
Electrical Machinery	6.3	7.4	7.3	7.3	0.0
Motor Vehicles	7.0	7.4	7.8	7.8	0.0
Nonauto Transp Eq & Misc Manu	6.3	7.2	7.8	7.8	0.0
Instruments	5.8	7.2	7.4	7.4	0.0
Nondurable Goods					
Food and Beverages	6.8	7.2	7.4	7.4	0.0
Tobacco	7.5	7.4	6.6	6.6	0.0
Textiles	7.2	8.1	8.5	8.5	0.0
Apparel	5.9	6.8	7.1	7.1	0.0
Paper	7.8	9.1	9.1	9.1	0.0
Printing and Publishing	6.9	7.6	8.0	8.0	0.0
Chemicals	6.9	8.0	8.5	8.5	0.0
Petroleum	4.5	7.8	7.5	7.5	0.0
Rubber	6.8	7.4	7.9	7.9	0.0
Leather	6.3	7.2	6.9	6.9	0.0
Transportation	5.6	6.0	6.2	6.2	0.0
Commercial	4.4	4.9	5.0	5.0	0.0
Utilities	3.9	4.6	4.8	4.8	0.0
Synfuels	4.5	7.8	7.5	7.5	0.0
Communications	5.7	7.1	7.3	7.3	0.0

Table 4: Tax Lives (Years)

				Baseline	Treasury Alternative (Scenarios 1 & 2)
	1975	1980	1985	1990	1990
Farm	14.2	13.8	7.4	7.4	13.8
Mining	21.5	20.6	10.9	20.0	16.0
Durable Goods					
Lumber	13.2	12.8	7.1	7.1	11.1
Furniture	18.7	18.7	9.0	9.0	15.1
Stone, Clay and Glass	16.5	16.2	8.6	8.6	15.3
Primary Metals	18.4	16.7	8.9	8.9	14.9
Fabricated Metal Product	15.9	14.3	7.4	7.4	15.0
Nonelectrical Machinery	17.0	15.9	7.8	7.8	12.5
Electrical Machinery	15.5	14.6	8.3	8.3	14.6
Motor Vehicles	12.5	13.0	6.1	6.1	12.2
Other Transp Equip	17.2	15.8	7.3	7.3	15.0
Instruments	18.7	16.5	8.6	8.6	16.5
Nondurable Goods					
Food and Beverages	16.9	15.7	8.0	8.0	14.7
Tobacco	17.6	20.2	12.6	12.6	15.0
Textiles	17.8	14.4	7.4	7.4	15.2
Apparel	17.8	15.9	8.1	8.1	15.5
Paper	16.6	15.3	8.4	8.4	17.5
Printing and Publishing	15.7	15.2	7.4	7.4	17.4
Chemicals	13.8	14.4	6.8	6.8	18.3
Petroleum	23.4	20.6	12.0	12.0	21.7
Rubber	17.3	16.5	8.0	8.0	17.2
Leather	16.7	15.0	8.8	8.8	18.0
Transportation	23.4	22.6	12.0	12.0	20.0
Commercial	21.5	20.6	10.9	10.9	16.0
Utilities	34.2	33.5	18.2	18.2	25.0
Communications	24.1	23.2	12.4	12.4	20.0

Chairman LAFALCE. Revenue neutral and growth neutral. How about equity neutral?

Mr. BEHRAVESH. Equity versus debts, or equity in terms of income distribution? Well, you didn't ask me to address that issue, and I didn't. But I don't think it worsens the income distribution as far as I can tell on the income tax side.

Chairman LAFALCE. A major omission.

Our next witness will be Prof. Don Fullerton, who coauthored the study of the American Enterprise Institute.

STATEMENT OF DON FULLERTON, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. FULLERTON. Thank you, Mr. Chairman.

I am very grateful for this opportunity to come and testify about some of the research I have been doing.

I think, because of a very solid explanation and groundwork laid by Mr. Behravesh, I won't go into great detail on the cost of capital or some of the effects of the current tax system, but I would like to do three things briefly.

One is to lay out some of the extreme distortions inherent in the current system just to try to explain how some of these can come about.

Second, to try to explain some of the problems inherent in any kind of study that would like to measure the cost of capital and the effect on investment.

And then third, to summarize the effects of this study you just mentioned a few minutes ago.

In some recent research, I have been working on the oddities of the current patchwork we have for the corporate tax system. We also took another look at what one currently thinks of as the double taxation of corporate income.

We know that certain investments pay a high corporate tax, get no investment tax credit, and may get no interest deductions if they are financed by equity. And then if the shares are held by households, there could be additional high personal taxes paid on dividend receipts.

In such cases, the double taxation story certainly applies, and I have measured that the effective tax rate on such an investment can be over 100 percent, including the corporate tax plus the personal tax plus the property tax. Since the three of those tax systems do not work together in a coherent fashion, the tax rate can be more than 100 percent of the income from the asset.

In the other extreme, however, it is possible to take an investment that does get an investment tax credit, like a machine. If it is financed by issuing debt and if it gets accelerated depreciation allowances, there is a combination of subsidies at the corporate level which could completely outweigh the tax at the corporate level on the income from the asset.

The corporation gets this subsidy in the form of reduced taxes that they would have to pay on other income, so it is, for many corporations, the same as the Government writing a check to the corporation for undertaking such an investment with these high investment tax credit rates, accelerated depreciation allowances, and interest deductions.

For such equipment, the property taxes may be very low and the personal taxes may be zero, if the bonds are sold to a tax-exempt institution. So we get interest deductions at the corporate level and no subsequent personal tax on the interest receipts.

I have estimated that the effective tax rate on that kind of an investment can be 100 percent subsidy; namely, a situation where the investment is literally earning nothing, but it is undertaken anyway, because the firm can earn a normal rate of return on the investment where that entire return is provided by the Government in the form of these investment tax credits and subsidies.

Well, we next look at the combination of all those different kinds of investments. Some are taxed at very high rates and some are taxed at very low rates. We then see what happens in the overall tax system.

I have estimated that the combination of all corporate taxes, personal taxes on the average new investment in this country is really only about 30 percent.

That is to say, because of the investment tax credits and accelerated depreciation allowances for some assets, in spite of high taxes on other assets, the overall rate is fairly low at 30 percent. Moreover, eliminating the corporate tax altogether, which I wouldn't necessarily view as a viable political option, results into an effective tax rate that goes up, from 30 to 32 percent.

That is to say, the corporate tax on the whole, for the average new investment in this country, is providing a net subsidy. The credits on some assets outweigh the high tax on others.

The next point I think would be to look at some of the justification for how some of these incoherent features got into the present tax code.

The investment tax credit, for example, was originally instituted as a stabilization tool. That is, it was used in the 1960's in an off-again/on-again way so as to provide temporary stimulus to the economy. And it was given for equipment only, because equipment could be undertaken rapidly, put in place in a rapid fashion so as to get the economy moving again.

There would be long lags, perhaps, with investment in structures, so it would be difficult to get temporary stimulus is structures, because it wouldn't be undertaken quickly enough.

Well, that whole justification for the investment tax credit went out the window once it was made permanent in the 1970's, and we were left with a situation where the credit gives particular incentive for one kind of asset over another.

Frankly, I don't happen to think that the Government knows more than the private sector about what kind of investments they ought to be undertaking.

I think that it would be wise to approach this whole problem with simply the view that businesses know what is best for their own production efficiency. And if they know what kind of investments to undertake, one would think that the best industrial policy would be one that would not interrupt and influence those efficient decisions they would have made on their own.

One of the original justifications for accelerated depreciation allowances is associated with the effect of inflation eroding the real value of these deductions. Well, that was recognized as a somewhat ad hoc offset to inflation, although it was fairly workable for a good number of years. With high and particularly variable inflation rates, it really doesn't work as well.

The Treasury proposal, which is now on the table, really tries to take that problem in a comprehensive fashion and tries to eliminate the influence of inflation on the real value of those depreciation allowances.

Turning, then, to some aspects of the Treasury plan and the problems in measuring its effects, I should first of all note that I haven't read the Wharton study carefully yet, and so I don't mean to make any comments about that study in particular.

But I have seen others, and I know some of the problems of measuring the costs of capital. I just would try to remind the audience of some of those problems.

First of all, some of these kinds of studies look particularly at changes in the corporate tax system. For something like the Treasury proposal, which proposes to raise corporate taxes by 25 percent and lower personal taxes, it looks like an increase in the taxes on business income.

I would argue that this first-blush approach at the problem is really very misleading, because the incentive to save and invest depends upon the total wedge between the pre-tax return of the corporation and the after-tax return to the individual saver. And that total wedge, the total set of taxes on that money that is saved and used for corporate investment, depends not only on the corporate taxes, but on the sum of corporate and personal taxes in a way that I was just talking about.

In particular, looking at corporate taxes only is misleading for a reform like the Treasury plan, because part of the way in which the Treasury plan would raise corporate taxes has a direct and essential counterpart in the way in which personal taxes are reduced.

Take the indexing of interest income. When that taxation of interest income is on a real basis instead of a nominal basis, the corporation gets a smaller deduction because they get to deduct only the real interest payments instead of the nominal interest payments. But for the same reason, individuals are taxed only on the real interest income and not on their nominal income.

So those two things go hand in hand, and they offset each in a way that might have absolutely no impact on the incentive to save and invest in total. They simply would eliminate the effects of inflation, where more of the tax happens to be collected at the corporate level, because they are getting only real interest deductions, and less of the tax happens to be collected at the personal level where they are getting taxed on only real interest received. There may be no real changes in total taxes at all.

The point that it is a bit misleading to look only at the corporate side.

Another kind of problem in measuring the cost of capital, or in talking about whether there is additional incentive to investment, is associated with what we think the rate of inflation is going to be.

If we assume the rate of inflation is going to be fairly high, then ACRS deductions may not be sufficient to cover the depreciation and the effective tax rates might end up being very high under the current system. The Treasury plan could look like it is going to lower effective tax rates.

If, instead, you assume the inflation rate is low, and we don't know what it is going to be, then ACRS may be more than adequate depreciation deductions, and we would currently have very low effective tax rates. The Treasury plan might look like it is going to raise the effective tax rate and the cost of capital.

Well, whether the Treasury plan is going to raise the effective tax rate and the cost of capital or lower it depends on assumptions about what we think the future rate of inflation is going to be. I simply mean to point out that the assumption is not obvious, the estimates are not unambiguous.

Whatever the Treasury plan does to the cost of capital and total investment, and whether it is growth neutral, as was discussed a few moments ago, none of these available studies capture adequately what it does to the efficiency in the use of a given amount of capital.

That is to say, I don't know whether it is going to raise the cost of capital and be antigrowth or lower the cost of capital and be progrowth, and it is probably not going to be a big change in either direction.

But I think the point of the Treasury plan had almost nothing to do with that. Rather, because it is revenue neutral, it is really based on the idea of trying to remove some of the distortions in the firms' decisions about the efficient use of capital.

Now, three of us at AEI have undertaken this preliminary project. Again, I don't think anybody should put too much stock in any one set of numbers. The only way we can get at the truth here would be to compare a number of different studies.

This is one contribution, and could influence some thinking on the issue, perhaps. But we don't pretend to have the final answer on what the Treasury plan is going to do.

In any case, we measured the effective tax rates for 20 different sectors in the economy. Some of them go up; some of them go down.

I have a copy of the paper here which I can hand over to you or your staff to look at further.

Over all, the cost of capital comes down slightly the way we did these estimates, but, as I said, I don't think that is unambiguous. But we do measure the efficiency in the use of this capital and the way in which capital is combined with labor to produce outputs.

What we find is that the increased value in national output from using capital more efficiently would, on the whole, amount to about a 1-percent increase in the value of output.

That is to say, in general, not looking at distributional effects again, we would all be better off by about 1-percent per year than we are under the current system if something like this were enacted.

That is equivalent to a one-time wealth effect or gift of something more than $400 billion. So I think that is nothing to sneeze at, and it is something that is worth taking quite a further look at and considering very seriously.

Thank you.

[The prepared statement of Mr. Fullerton follows:]

Prepared Statement

of

Don Fullerton

Associate Professor of Economics, University of Virginia
Visiting Scholar, American Enterprise Institute

before the

Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

March 13, 1985

Mr. Chairman and members of the committee, I am very grateful for this opportunity to come and testify about the sectoral consequences of corporate taxation in general, and about the Treasury Department Tax Reform Plan in particular. I have been doing research in this general area for about eight years, and I have just completed a project evaluating some of the latest suggested tax reform proposals.

The corporate income tax is an incoherent patchwork of investment tax credits for only some assets, depreciation lifetimes that bear little or no resemblance to economic lifetimes, accelerated allowances for depreciation, and deductions that apply to interest but not to dividends. These peculiarities serve to distort choices about what kind of assets to buy, where to put them, and how to finance them. As a result of these distortions, the real output of our society is reduced. It becomes important to consider not just whether there is adequate total investment in this country, but whether any given total is being used correctly.

You have all heard that corporate profits are taxed once at the corporate level and again at the personal level when they are paid out in dividends. This "double taxation" discourages investment and thus reduces productivity. Certainly this statement is true for some investments. Suppose that a corporation buys a new building and finances the project by selling new shares to households. It receives no investment tax credit, only delayed depreciation allowances, and no deduction for any dividends paid to the new shareholder. These shareholders pay personal tax on dividend receipts. I have estimated that the total corporate, personal, and property tax on such a new investment can be expected to reach 110 percent of the income from the project.

On the other hand, suppose that the corporation decides to invest in new machinery and to finance it by selling bonds. Suppose further that the bonds are sold to a tax-exempt institution such as a pension fund, Keogh account, charity or university. In this case the corporation receives a ten percent investment tax credit, accelerated depreciation allowances, and a deduction for all of the interest paid out on the bonds. Because there is no subsequent tax at the personal level, I have estimated that the total effective corporate and property tax rate on the income from this project can be a minus 105 percent.

Not that much new investment is taxed at rates over 100 percent, but almost 30 percent of it is taxed at rates between 80 and 90 percent. Not that much is taxed at rates below a minus 100 percent, but plenty is taxed at rates less than zero. The corporate tax system subsidizes a substantial amount of investment in this country, with a considerable revenue cost.

When I average all the different rates together, I get an overall effective tax rate of 30 percent under current law. This includes corporate taxes, personal taxes, and property taxes on the average new investment. If the corporate tax is eliminated, this effective tax rate goes up, to 32 percent. The combined effect of credits, accelerated allowances, and interest deductions is that they more than offset the corporate tax. The average new investment is subsidized at the corporate level. The only corporate tax revenues coming in are from taxing old assets, and even those taxes are reduced by the benefits provided to new investments.

The justification for each of these features warrants another look. The investment tax credit was originally instituted as a stabilization tool, to provide temporary stimulus during recessions of the 1960's. It was given for equipment only, because that kind of investment could take place more quickly to get the economy moving. Since the credit has become permanent, the original justification has disappeared. What's left is an incentive to invest in one kind of asset instead of another, so that firms' own efficient allocation decisions are distorted.

Accelerated depreciation allowances have been justified as a response to high inflation rates which erode the real value of depreciation allowances based on historical cost. ACRS has the appeal of simplicity, with only four categories of asset lifetimes, but the problem is that assets actually wear out at more than four different rates. The result is further misallocation of resources.

A substantial reform has been suggested by the U.S. Treasury Department. In fact, the pervasive nature of the Treasury proposal creates important specific problems for economic analysis. First, many existing studies abstract from all personal tax changes in order to concentrate on corporate or business tax provisions. Since the Treasury plan raises corporate taxes, these studies often find an increase in the "user cost of capital" or the marginal effective corporate tax rate. The simplification of ignoring the personal side is not appropriate for the Treasury plan, however, because the corporate tax increases are an intentional counterpart to specific reductions of personal taxes. Both tax systems affect the wedge between the pre-tax return on the investment and the post-tax return to the saver.

For a specific example of this interdependence, consider the proposal to index interest paid and received. The reduction of corporate deductions for nominal interest payments is offset by the reduction of personal tax on nominal interest receipts. More of the tax on interest may be collected at the corporate level instead of at the personal level, but the two changes necessarily go together. It is misleading to concentrate on just corporate tax increases, since the total tax and the net effect on incentives may be entirely unchanged.

Second, not all of these studies are uniformly careful to distinguish between estimates of changes in corporate revenue and estimates of changes in investment incentives. These differ in part because each year's revenue reflects the timing of tax collections, while incentives depend on the present value of tax collections. Changes in the deferral of tax liability through depreciation allowances can affect the estimates of revenue for particular years without affecting the present value of tax or incentives in the same way.

Third, most of the studies assume that corporations do not change their mix of debt and equity. Some do not even attempt to include the Treasury's proposal to allow corporations to deduct 50 percent of the dividends they pay. In fact, the Treasury plan provides incentive to use more equity finance, both because of this dividend deduction and because of the indexation of deductions for interest paid. The costs of debt finance and equity finance differ, so any change in debt/equity ratios will affect the overall user-cost estimates.

Fourth, results are sensitive to a host of other assumptions about how businesses behave. Extra taxes are paid when firms voluntarily use FIFO inventory accounting or longer than minimum depreciation lifetimes, but it is unclear whether these discretionary taxes should be added to other nondiscretionary taxes in calculating the wedge associated with making new investment. Since the existing wedge is ambiguous in this way, the Treasury plan's impact on this wedge is also ambiguous.

Fifth, results depend on the level of disaggregation. Actual data on more disaggregated assets and industries take time to acquire and use, but they are essential for meaningful comparisons of alternative tax regimes.

Sixth, results are very sensitive to assumptions about the future rate of inflation. In the existing system, depreciation allowances are accelerated partly to offset the fact that inflation reduces the real value of allowances. If inflation is expected to be low, the acceleration may be too generous; but if inflation is high, allowances may be insufficient. The Treasury plan proposes to remove the dependence on inflation. If the assumed inflation rate and current effective tax rates are low enough, the Treasury plan would raise effective taxes; if the assumed inflation rate and current effective tax rates are high enough, then the Treasury plan would lower effective tax rates.

A final caveat is perhaps the most important. These studies measure the incentive to invest in general capital formation, or in a number of particular assets. I have argued above that the Treasury plan for some assumptions can be shown to raise effective tax rates and reduce capital formation, and for other assumptions can be shown to lower effective tax rates and encourage capital formation. But whatever the Treasury tax plan does to the total stock of capital, none of these studies measures changes in the efficiency of its use.

Current law provides tax incentives to invest in some assets more than others, and in some industries more than others. Special investment tax credits and accelerated depreciation allowances serve to push economically inferior investment projects ahead of more productive investment projects, and total output suffers. Under the Treasury tax plan, without these special tax breaks, businesses would be encouraged to reallocate their capital toward whatever projects produce the highest return. Thus, even if the stock of capital does not change, it could be used more efficiently to produce more output.

Along the lines of this final caveat, three of us associated with AEI have undertaken a preliminary study of the efficiency of investment under the Treasury Plan as compared to the current system. We measure the effective tax rates for twenty different sectors and calculate the net value of output under alternative tax regime scenarios. I would counsel against putting too much stock in any single set of numbers, but our preliminary estimates suggest that the Treasury plan would slightly reduce overall effective tax rates and help to level the playing field for investment: the value of national output could be almost one percent higher, equivalent to a one-time wealth increase of over $400 billion.

With similar proposals emanating from the executive branch and from both parties in the legislative branch, this year seems like an opportune time to undertake fundamental tax reform based on the common ground among these proposals. And while deficit reduction may take higher priority, I hope that priority remains high for a reform that could increase the general welfare by an amount even close to the large amount that these preliminary estimates suggest.

Chairman LaFalce. Thank you, Professor Fullerton.

We will next hear from Prof. Alan Auerbach of the University of Pennsylvania.

STATEMENT OF ALAN J. AUERBACH, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. Auerbach. Thank you very much, Mr. Chairman.

I am pleased to have the opportunity to appear today and share with you my views on the sectoral consequences of corporate taxation in the United States.

In response to your opening charge to this panel, I would like to start by saying that my impression of the testimony of the two previous members of this panel is that the difference in opinion one might have supposed existed is really much smaller than it might have seemed. And I think that is generally true of perceptions outside of the economics profession about arguments within the profession.

I think disagreements among economists about what the Treasury proposal would do are actually relatively small compared to the way they have been characterized by people with particular interests.

Well, as I said, I am pleased to be before this committee.

Chairman LaFalce. Although, if I may just interrupt, in the question and answer period, I do want to get to the question of whether there has or hasn't been a change in the opinion of Wharton Econometrics, or whether there is perhaps a slightly different nuance in their opinion now from the time of their original study.

I suspect, from what I read and what I heard, there may well be.

Mr. Auerbach. Nevertheless, and there are those who would issue more extreme views, I will deal with them in my testimony.

This is obviously a terribly important issue. It is so important that it has been considered practically every year in major tax bills during the current administration. And the Treasury proposes to consider it again in its new proposal of 1984.

Congress is currently considering many other options, the most prominent of which are the Bradley-Gephardt Fair Tax proposal, and the recently revised Kemp-Kasten Fair and Simple Tax scheme.

In my comments I will touch on several points, some dealing with the recent impact of the corporate tax and others on the desirability and potential effects of the proposed tax changes that are currently under study.

At the very least, I hope I can convince you that the hysteria abroad about a possible collapse in business investment and the stock market, if one of these proposals were enacted is unfounded for two very basic reasons: The current accelerated cost recovery system is not nearly as successful an economic program as some would have us believe, nor would any of the proposals increase business taxes enough to lead to the catastrophes that have been predicted.

I want to begin my comments with a review of the recent past, corporate taxes since 1981.

In fiscal year 1983, corporation income taxes represented a postwar low of 6.2 percent of Federal revenue. This was due in part to the serious recession that economy was in at the time, but it was also certainly due to the tax incentives introduced in 1981.

In a recent study, I found that in 1984 many investments in depreciable capital faced negative tax rates—something alluded to by Mr. Behravesh. That is, they yield investors a greater return after taxes than before. This is particularly true of investment qualifying for the investment tax credit.

This reduction in effective tax rates on corporate investment that occurred in 1981——

Chairman LAFALCE. Would you expand on that at some point?

Mr. AUERBACH. I would be happy to do that at the conclusion of my testimony or I can answer right now, if you like.

Chairman LAFALCE. Later.

Mr. AUERBACH. Fine.

This reduction in the effective tax rates on corporate investment has had the positive effect of reducing the disincentive facing this type of investment relative to that undertaken outside the corporate sector, particularly housing.

Some have even suggested that ACRS is the major reason for the strong recovery of business fixed investment that has occurred during the past couple of years, during this recovery. I have seen studies citing the strength of investment in this recovery relative to previous postwar cycles.

On this point, I have a number of criticisms. First, this has been one of the severest of the postwar recessions, the worst as measured by the unemployment rate. To recover more quickly from a lower trough is surely a Pyrrhic victory.

If one considers the level of real net nonresidential fixed investment, which is probably the single most relevant investment statistic for questions about capital's contribution to productivity growth——

Chairman LAFALCE. What was that statistic?

Mr. AUERBACH. It is real, so is adjusted for changes in the price level.

Chairman LAFALCE. I understand.

Mr. AUERBACH. Nonresidential, net of depreciation. So it is the rate at which fixed nonresidential capital stock is growing in real terms.

Chairman LAFALCE. Yes.

Mr. AUERBACH. One finds it was at the same level as a fraction of GNP in 1984, 3.8 percent, as it was in 1979, before the recent recessions.

So I think we are right on track in terms of investment given past history.

Now, while some econometric models do find that investment is currently performing somewhat above predicted levels, my sense is this is not accounted for by the behavior of business as a whole, but rather that of specific industries, such as computers, where the growth has been unusually strong.

What is surprising to me, and I think one of the reasons why the models do find investment is stronger than predicted, is not that investment is at a high level historically, which it is not, but that it is not doing worse, given the historically high real interest rates with which businesses today must deal.

Just to give you a review of this, in 1980, the real interest rate, equal to the average commercial paper rate less the rate of change in the GNP deflator—and my statistics come right out of the Economic Report of the President—was 3.1 percent. This rose to 5.2 percent in 1981, 5.9 percent in 1982, 5.1 percent in 1983 and 6.5 percent in 1984.

If one considers instead the real, after-tax interest rate facing corporations, taking account of the deductibility of interest at the corporate rate, the rise was even more marked, from −2.6 percent in 1980 to 1.8 percent in 1984. So that is a change of 4.4 percentage points.

Studies of the effects on the cost of capital facing firms have suggested that the 1981 act lowered this cost by roughly 1 percentage point, give or take a little bit. Hence, compared to the increase in real interest rates that we have observed, one would have expected very weak investment performance, despite the tax liberalization. I think that is perhaps where the puzzle is.

Even if one grants that avoidance of this catastrophe is due, in part, to the introduction of ACRS, there remains another legacy as well. If business investment was encouraged over all, its misallocation was also increased, and that point has also been made already today.

There is ample evidence, including statistics published in the 1982 and 1985 Economic Reports of the President, that since 1981 businesses have faced very different effective tax rates on their investments depending on their industries and their choice of assets.

In a recent study, I estimated that this distortion caused a value of lost corporate output in 1984 of approximately $5.8 billion, which is a number substantially smaller than the one Don Fullerton just cited. However, his is a measure of the entire economy as opposed to the corporate sector, so I am not sure those numbers are entirely contradictory.

This is the amount that was lost because investments were being chosen on the basis of distorted tax rules. Despite the low current levels of corporate tax collections, relative to the 1960's and 1970's, I have found that the magnitude of this distortion has not declined in recent years.

Two of the three proposals mentioned above, Treasury and Bradley-Gephardt, were designed to remove these distortions currently influencing the allocation of assets within the corporate sector. I think there is general agreement that they would succeed in this.

My own work, which is focused on Bradley-Gephardt, finds it would essentially remove all distortions. I think the same could be said of the Treasury plan. As I understand the remaining plan, Kemp-Kasten, it would have the effect of offering all the equity financed investments a zero tax treatment on all assets.

Now, the real debate, I think, over the Treasury proposal in particular as opposed to the current system is about the effect that would have on the overall incentive to invest which, as I indicated already, has been improved under ACRS.

Some econometric models have forecast a sharp decline in business investment and in the stock market if the Treasury tax plan were passed.

I think both of these predictions, particularly the second, is greatly overstated.

You have already heard of the study by Don Fullerton, and a recent one by the Congressional Research Service of the Treasury tax plan found that the effective tax rates facing new corporate fixed investment would rise, but to levels below those that prevailed before 1981.

It also found that, among fixed investments, structures would gain and equipment would lose. That is consistent with what you have heard today.

Further, if one takes account of inventory investment as well, it estimated that the overall tax rate on investment by corporations would actually decline slightly under the Treasury plan, which is perfectly consistent with the results of the study Don Fullerton summarized for you.

Given these results, I would suggest again this is consistent with what you have heard today that the overall effect of the Treasury plan on investment, is likely to be relatively minor and that the conduct of fiscal and monetary policy, in particular the size of the Government deficit and the growth rate of money stock, will be more crucial in determining the strength of investment in the coming years than the exact form of the tax system facing corporations.

There is one characteristic of the Treasury plan and Bradley-Gephardt as well that I would prefer to see changed. Both of these plans would immediately reduce the top corporate tax rate while at the same time scaling back tax preferences, depreciation allowances and investment tax credit.

By doing so, aside from the effects on new investment that you have already heard about, they would provide windfalls to the owners of existing assets, fixed assets, who pay taxes at lower rates on their future income than had been anticipated when the investments were originally made.

One would expect these windfalls to be reflected in the stock market, quite substantially in fact, and this is a fact that I just can't square with the predictions of DRI that the stock market would go down. I am aware of other studies that predict it would go up.

I think it must be recognized that movements in the stock market and movements in investment really are quite independent and one could see investment encouraged or discouraged without seeing the stock market go down. That is one of the reasons I am skeptical of such studies.

These windfalls, I think, which would certainly occur under the Treasury plan, could be reduced by a gradual phasing in, for example, by reducing the corporate rate and the investment tax credit in stages over a period of several years.

The higher tax rate could be used to pay for the remaining credit, with a greater investment stimulus than would result from an immediate switchover. In my view, even a phasein of only the rate cut would be preferable to no phasein at all.

One shouldn't lose sight of the fact that there is much more to be said in favor of these tax reform plans than just the effect on investment as a whole.

The move toward a more rational treatment of depreciation under either Treasury or Bradley-Gephardt would lessen the problem of tax losses that was worsened with the introduction of ACRS and its front-loaded investment credits and deductions.

The failure of Safe-Harbor Leasing in 1981 demonstrates the difficulty of dealing indirectly with this type of problem, once created.

Finally, let me issue a caveat about revenue calculations. The order of the day now seems to be revenue neutrality because if Congress decides it doesn't want to cut taxes and the President decides he doesn't want to raise them, then there isn't a lot of scope for movement in between. And so one can assume without even reading, any proposal that comes to Congress today will be revenue neutral.

But I think the revenue neutrality is something of an illusion. Certainly these proposals either intentionally or in some cases unintentionally appear to be revenue neutral when they really aren't.

For example, opponents of the Treasury plan often quote a statistic about the amount of additional revenue it would raise from corporations over the first 5 years after its enactment. This is a seriously misleading figure.

The primary reason for this increase is the change in the timing of tax receipts from corporations. One way of putting it is that, under ACRS, corporations are accumulating amounts of deferred taxes that they eventually will have to pay back due to the acceleration of depreciation allowances.

These would no longer arise under the Treasury plan, because the Treasury plan provides for the correct measure of depreciation. If accrued deferred taxes we currently have were included in tax revenue calculations, the move from ACRS would appear to be much less of a tax increase. This has two implications.

First, the plan is not as bad for investment as some would infer from revenue estimates, which is only consistent with studies I have cited and the testimony you have heard.

Second, unfortunately, the plan is not as revenue neutral as it appears.

I don't think the Treasury proposal was designed with the intent of misleading people. I think it was designed on the basis of what the Treasury people thought was good, and because of a change in timing, it turns out this way.

The Kemp-Kasten proposal is new in that it would space out the deductions over the years, but then give, in a sense, interest credits to the people who have to defer deductions to keep value of the deductions the same.

The major reason one can think of doing the proposal this way is to make a short-run revenue loss look smaller from such a proposal.

Deferring tax deductions with interest doesn't change their value to the firm and it shouldn't change the perceived value to the Government either, which means that one should view this proposal as a present proposal to have immediate expensing of investments by business, and view it for the revenue-reducing proposal that it is, a tax cut.

In conclusion, at no time in recent memory has so much thought and effort been devoted to reforming corporate tax. There are many other aspects of the Treasury plan that I have not discussed but that deserve further consideration, including the indexing of interest payments and depreciation allowances and the partial deduction for dividends paid.

All in all, it represents a serious option, one that, with modifications, I would view as a major improvement over our current system of corporate taxation.

If you will allow me a lapse in grammar, some have protested against the proposed Treasury changes saying "If it ain't broke, don't fix it." To these individuals, I would suggest a closer examination both of the status quo and the proposed reforms.

[The prepared statement of Mr. Auerbach follows:]

Testimony Before the Subcommittee on Economic Stabilization,
House Committee on Banking, Finance and Urban
Affairs

by Alan J. Auerbach, Associate Professor of Economics,
University of Pennsylvania, and Research
Associate, National Bureau of Economic Research

March 13, 1985

Mr. Chariman and Members of this Subcommittee:

I am pleased to have the opportunity to appear today and share with you my views on the sectoral consequences of corporate taxation in the United States. This is a terribly important issue, having arisen in the debate over provisions in each of the last three major tax acts passed by Congress, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984. It is even more central to the provisions of the primary alternatives currently being considered by Congress, the Treasury's plan of November, 1984, the Bradley-Gephardt Fair Tax proposal, and the recently revised Kemp-Kasten Fair and Simple Tax scheme.

In my comments, I will touch on several points, some dealing with the recent impact of the corporate tax and others on the desirability and potential effects of the proposed tax changes that are currently under study. At the very least, I hope I can convince you that the hysteria abroad about a possible collapse in business investment and the stock market if one of these proposals were enacted is unfounded for two very basic reasons: the current Accelerated Cost Recovery System is not nearly as successful an economic program as some would have us believe, nor would any of the proposals increase business taxes enough to lead to the catastrophes that have been predicted.

The Corporate Tax Since 1981

In fiscal year 1983, corporation income taxes represented a postwar low of 6.2 percent of federal revenue. This was due in part to the serious recession that economy was in at the time, but also to the tax incentives introduced in 1981. In a recent study, I found that, in 1984 many investments in depreciable capital faced negative tax rates: they yield investors a greater return after taxes than before. This is particularly true of investment qualifying for the investment tax credit.

This reduction in effective tax rates on corporate investment has had the positive effect of reducing the disincentive facing this type of investment relative to that undertaken outside the corporate sector, particularly housing. Some have even suggested that ACRS is the major reason for the strong recovery of business fixed investment that has occured during the past couple of years, citing the strength of investment in this recovery relative to previous postwar cycles.

On this point, I have a number of criticisms. First, this has been one of the severest of the postwar recessions, the worst as measured by the unemployment rate. To recover more quickly from a lower trough is surely a Pyrrhic victory. If one considers the level of real net nonresidential fixed investment, probably the single most relevant investment statistic for questions about capital's contribution to productivity growth, one finds that it was at the same level as a fraction of GNP in 1984, 3.8 percent, as it was in 1979, before the recent recessions.

While some econometric models dc find that investment is currently performing somewhat above predicted levels, this is not accounted for by the behavior of business as a whole, but rather that of specific industries, such as computers, where growth has been unusually strong. What is surprising is not that investment is at a high level, which it is not, but that it is not doing worse, given the historically high real interest rates with which businesses today must deal.

In 1980, the real interest rate, equal to the average commercial paper rate and the GNP deflator, was 3.1 percent. This rose to 5.2 percent in 1981, 5.9 percent in 1982, 5.1 percent in 1983 and 6.5 percent in 1984. If one considers instead the real, after-tax interest rate facing corporations, taking account of the deductibility of interest at the corporate rate, the rise was even more marked, from -2.6 percent in 1980 to 1.8 percent in 1984. Studies of the effects on the "cost of capital" facing firms have suggested that the 1981 act lowered this cost by roughly one percentage point. Hence, one would have expected very weak investment performance, despite the tax liberalization.

Even if one grants that avoidance of this catastrophe is due, in part, to the introduction of ACRS, there remains another legacy as well. If business investment was encouraged overall, its misallocation was also increased. There is ample evidence, including statistics published in the 1982 and 1985 Economic Reports of the President, that since 1981 businesses have faced very different effective tax rates on their investments depending on their industries and their choice of assets. In a recent study, I estimated that this distortion caused a value of lost corporate output in 1984 of approximately 5.8 billion dollars. This is the amount that was lost because investments were being chosen on the basis of distorted tax rules. Despite the low current levels of corporate tax collections, the magnitude of this distortion has not declined in recent years.

The New Proposals

Two of the three proposals mentioned above, Treasury and Bradley-Gephardt, were designed to remove these distortions currently influencing the allocation of assets within the corporate sector. I think there is general aggreement that they would succeed in this. My own work indicates that Bradley-Gephardt would essentially remove all such distortions. The remaining plan, Kemp-Kasten, would, in its current version (as I understand it) offer the equivalent of zero tax treatment on all fixed assets, thus also insuring neutral treatment. The real debate is about the effect of these programs on the overall incentive to invest which, as I indicated already, has been improved under ACRS. Some econometric models have forecast a sharp decline in business investment and in the stock market if the Treasury tax plan were passed. I think both of these predictions, particularly the second, is greatly overstated.

A recent study by the Congressional Research Service of the Treasury tax plan found that the effective tax rates facing new corporate fixed investment would rise, but to levels below those that prevailed before 1981. It also found that, among fixed investments, structures would gain and equipment would lose. Further, if one takes account of inventory investment as well, it estimated that the overall tax rate on investment by corporations would actually decline slightly under the Treasury plan. The same conclusions were reached in a recent study published by the

American Enterprise Institute.

Given these results, I would suggest that the overall conduct of fiscal and monetary policy, in particular the size of the deficit and the growth rate of the money stock, will be more crucial in determining the strength of investment in the coming years than the exact form of the tax system facing corporations.

There is one characteristic of Treasury and Bradley-Gephardt that I would prefer to see changed. Both would immediately reduce the top corporate rate while at the same time scaling back tax preferences. By doing so, they would provide windfalls to the owners of existing fixed assets, who would pay taxes at lower rates on their future income than had been anticipated when their investments were originally made. One would expect these windfalls to be reflected in the stock market, a factor accounted for by few forecasters.

These windfalls could be reduced by a gradual phasing in of one of the new plans instead, for example by reducing the corporate rate and the investment tax credit in stages over a period of several years. The higher tax rate could be used to pay for the remaining credit, with a greater investment stimulus than would result from an immediate switchover. Even a phase-in of only the rate cut would, in my view, be preferable to no phase-in at all.

There is much more to be said in favor of the tax reform plans. The move toward a more rational treatment of depreciation under either Treasury or Bradley-Gephardt would lessen the problem of tax losses that was worsened with the introduction of ACRS and its "front-loaded" investment credits and deductions. The failure of Safe-Harbor Leasing demonstrates the difficulty of dealing indirectly with this problem, once created.

Revenue and Mirrors

Opponents of the Treasury plan often quote a statistic about the amount of additional revenue it would raise from corporations over the first five years after its enactment. This is a seriously misleading figure. The primary reason for it is the change in the timing of tax receipts from corporations. One way of putting it is that, under ACRS, corporations are accumulating amounts of deferred taxes due to the acceleration of depreciation allowances. These would no longer arise under the Treasury plan. If accrued deferred taxes were included in tax revenue calculations, the move from ACRS would appear to be much less of a tax increase. This has two implications. First, the plan is not as bad for investment as some would infer from revenue estimates. This is consistent with the results of the studied I cited earlier. Second, unfortunately, the plan is not as "revenue-neutral" as it appears.

The new Kemp-Kasten bill, which would offer depreciation deductions equal in present value to immediate expensing of investment but spaced out over several years, should for the same reason be seen for the tax reduction that it represents, annual revenue calculations aside. Deferring tax deductions with interest does not change theri value to the firm or the government.

Conclusions

At no time in recent memory has so much thought and effort been devoted to reforming the corporate tax. There are many other aspects of the Treasury plan that I have not discussed but that deserve further consideration, including the indexing of interest payments and depreciation allowances and the partial deduction for dividends paid. All in all, it represents a serious option, one that, with modifications, I would view as a major improvement to our system of corporate taxation. To those who would protest "if it aint broke, don't fix it," I would suggest a closer examination both of the status quo and the proposed reforms.

Chairman LaFalce. Thank you very much, Mr. Auerbach.

I doubt we have ever heard more expert testimony from three witnesses at one time.

I certainly think, after listening to you, that there is much more agreement than disagreement. It is probably difficult to find disagreement, as a matter of fact, but we will see if we can.

First, Mr. Behravesh, is there any difference now between your testimony today and the initial findings and conclusions of the Wharton Econometrics study?

Mr. Behravesh. Well, I think what you are referring to as the initial one is something we talked about in December and which got a lot of publicity. It is qualitatively the same as what I call scenario 1, in which there is no change in interest rates. As I pointed out, one of the biggest uncertainties is what does happen to interest rates.

In that study which is essentially the scenario 1 I presented today, you do get a small decrease, and I emphasized the word, "small," decrease in overall investment. Some industries, specifically those that depend on the investment tax credit and ACRS—the equipment intensive industries, do get hurt a fair amount. And those are the people that jumped on the study and made a lot of noise about it.

Chairman LaFalce. By those people you mean the National Association of Manufacturers?

Mr. Behravesh. I wasn't going to name any names, but they clearly——

Chairman LaFalce. They seem to be backtracking now, too.

Mr. Behravesh. That's correct. It was clearly something that they liked to see, and they obviously used it and overused it in some sense. So I think that the results were blown out of proportion. We still stand by the results. I think they are reasonable results.

What I have tried to do today is bracket the range of possibilities, because I think there is a lot of uncertainty about the impact of that provision on interest indexation. And I want to emphasize that.

Chairman LaFalce. I am going to do something that is very unfair, but it happens to us all the time. Rather than wait until the end of the hearing, I am doing it at the very beginning of the hearings.

Mr. Behravesh, if you had to vote yes or no, no amendments to the Treasury bill, how would you vote?

Mr. Behravesh. I would vote yes.

Chairman LaFalce. Mr. Fullerton.

Mr. Fullerton. Yes.

Chairman LaFalce. Mr. Auerbach.

Mr. Auerbach. Yes.

Chairman LaFalce. Two studies fault the Treasury's tax plan; one being Wharton and the other being the National Association of Manufacturers. There was an article, I think, in yesterday's paper that said the National Association of Manufacturers is now split and, therefore, is not taking an official position.

The ones most likely to oppose the plan would be the ones that oppose specific provisions within the plan—the realtors, the homebuilders, and specific associations, as opposed to larger groups or academic types.

Mr. **Behravesh**. If I could just jump in for a second, Mr. Chairman.

Chairman **LaFalce**. Sure.

Mr. **Behravesh**. I do think that there are particular industries that have benefited greatly from the existing tax system, and it is like taking candy away from these industries. They are obviously going to oppose it.

Chairman **LaFalce**. Sure.

Mr. **Behravesh**. They are not going to like it, the removal of these benefits, so I think these are the industries you are going to hear from in opposition.

Chairman **LaFalce**. Let's go into that a little bit.

Mr. Auerbach, you indicated—I don't think you were speaking about the tax code at large, but I think you were talking about ACRS in particular—correct me if I am wrong—created a negative tax rate.

Mr. **Auerbach**. That's right.

Chairman **LaFalce**. For a good many industries.

Mr. **Auerbach**. That's right.

Chairman **LaFalce**. Well, could we flesh that out a bit both with ACRS and the corporate tax code as a whole? What industries really have been benefiting from negative tax rates?

Mr. **Auerbach**. Well, according to my calculations, and I should qualify my statement by saying that these are calculations done for the year 1984 for fixed investment only. So I am considering the effective tax rate on equity financed investments by a typical corporation in one of these industries. I found that the construction industry, just to cite one example, was an industry that on its fixed investment was facing a negative tax rate in 1984 given the assumptions about inflation rates and so forth.

One has to make such assumptions because the tax system depends on the inflation rate. It is better to say that there are a lot of different assets that face negative tax rates, and the extent to which an industry overall received a negative tax rate or a very low tax rate depends very much on the extent to which it makes use of the investment tax credit, which is probably the single most important factor in determining the benefits from the tax system.

If one removed the investment tax credit, I think one would get rid of a lot of the distortions of the current tax system even without going from ACRS to the Treasury proposal.

Chairman **LaFalce**. I wasn't going to do this, but let me do it right now. It is one thing to be concerned about equity in the moral sense as opposed to the financial sense, and we ought to. It is another thing to be concerned about the budget deficit. And while the President apparently did not go along with any tax increases, apparently he is like 10 pounds of onions on that. Was that the quote of Larry Speakes? Maybe we could make the quote a little bit sweeter, and say we don't want to increase taxes, we just want to cut tax expenditures.

I don't know if he understands the difference, but there is a difference, and the investment tax credit could be one of those differences. Do you have any idea of how much money we would save or how much we would reduce the deficit in fiscal year 1986, 1985, if we eliminated investment tax credit?

Mr. AUERBACH. I have seen estimates of that done by the Treasury, but I would be guessing if I said about $30 billion, but I think it is in that neighborhood.

Chairman LAFALCE. In 1 year?

Mr. AUERBACH. Yes.

Chairman LAFALCE. Yes.

Mr. FULLERTON. As Professor Auerbach was saying earlier, all of us have concentrated on all the revenue neutral proposals that have come before Congress and not estimated things like that. I think probably the Treasury Department's Office of Tax Analysis is better at estimating those kinds of things than we are anyway. They have a larger data base. But I would emphasize one other thing about what Professor Auerbach just said about the negative effect of tax rates if I may.

His, the numbers he just quoted, were in reference to equity finance, in the financial sense, investments under the corporate income tax. I know he would agree with this because I have heard him say it before, if some of those investments are debt financed and particularly if some of the bonds are held by tax exempt institutions or pension funds and such, the effective tax rates can become even more negative so that it is not just the investment tax credit or just accelerated depression allowances——

Chairman LAFALCE. Most of those would be debt financed, wouldn't they?

Mr. FULLERTON. Well, there is some mixture, and industries differ, by the way, to some degree at least on the mixture of debt and equity. So while the numbers he was just quoting refer to rates that are made negative because of the investment tax credit, they would in general be even more negative to the degree that any industry uses debt finance and to the degree that pension and tax exempt recipients of interest have become larger over the years.

Chairman LAFALCE. Based upon your present recollection, what is the best study of the negative tax rates that exist right now?

Mr. AUERBACH. I am not sure. There is a very nice study, a book of which Don was a coeditor, which went through the analysis of the tax system of different countries including the United States. I am not sure that it is current, though. It was post-1981, and it did study the effects on different investments.

Chairman LAFALCE. Well, Professor Fullerton.

Mr. FULLERTON. Yes, there were estimates in that book that were intended to be comparable for all four countries for 1980, which meant that it was before ACRS was introduced. But in the U.S. chapter of that book I provided estimates for the 1981 law and the 1982 law, so it is essentially current.

Chairman LAFALCE. Is there any more recent, up-to-date analysis?

Mr. AUERBACH. Well——

Chairman LAFALCE. That you are aware of?

Mr. AUERBACH. I did studies for 1983 and have published a paper which I can——

Chairman LAFALCE. Would you give us your published paper?

Mr. AUERBACH. I would be happy to do that.

[The material referred to appears on p. 89]

Chairman LAFALCE. Thank you very much. Now, I asked you how you would go if you had to vote yes or no on the tax plan and all of you said, yes. But suppose it is not a question of yes or no. Suppose we can pick and choose. And suppose you were interested in raising revenues. Would the elimination or reduction of the investment tax credit be one of the first options or the first option that you would select, Mr. Auerbach?

Mr. AUERBACH. It would certainly be one of them. I could think of others as well.

Chairman LAFALCE. What others?

Mr. AUERBACH. Well, I think, the dividend paid deduction, although if we weren't worried about revenue it might be something that would be nice to have. It is probably not very efficient. Unless it were scaled back or limited in some way, it would be a good candidate for raising revenue.

Chairman LAFALCE. Professor Fullerton.

Mr. FULLERTON. I think the investment tax credit would go first in my book.

Chairman LAFALCE. Mr. Behravesh.

Mr. BEHRAVESH. I don't have a problem with what these two gentlemen said. I would agree with them on that.

Chairman LAFALCE. I am going to ask you two questions about economic dislocation. First, to what extent might we experience serious economic dislocation in general, and for specific industries, if the Treasury tax plan were adopted in toto, and then the same question, but only with respect to the investment tax credit.

Mr. AUERBACH. First of all, I think the major difference, or large part of difference would be gotten from the investment tax credit repealed; that the remaining differences are probably slightly less important in terms of the dispersion of incentives to invest.

The investment tax credit really is a very powerful tool. I guess my sense is that these could be fairly serious, certainly in certain areas in certain industries.

Chairman LAFALCE. Such as?

Mr. AUERBACH. I confess I am not an expert on the geographic mix of investments.

Chairman LAFALCE. We will be having subsequent hearings looking at specific——

Mr. AUERBACH. I think it is important to look at these issues, and that liberal phase-in policies ought to be considered. I don't think there is any reason why they shouldn't. They probably should have been considered in 1981 since tax reductions as well as tax increases can have dislocative effects.

Mr. FULLERTON. One of the aspects of these phase-in provisions that bothers me is related to confidence in the business community that the later stages of the phasein will actually take place. And I think we noticed some problem with that in 1981, when ACRS was being phased in.

I think to some extent even if it did occur, the way the phase-in plan was designed, there were some problems because firms were potentially holding off investment to wait to the time when depreciation would be even more accelerated, and that might have caused deeper recession in those early years. And then second, there is just uncertainty about whether the later phases were actually going to take place.

So subject to those caveats, I otherwise agree with what Professor Auerbach has said about the phase-in provisions, particularly the windfall nature of the gains to those with existing assets for whom the corporate rate would be immediately reduced. They put those investments into place, expecting a certain time frame. And we would be lessening their taxes without giving them necessarily anymore incentive to invest in that regard.

Mr. BEHRAVESH. I guess I am concerned about the dislocational possibilities, across industries. And I don't think either our study or any other study has really focused on that particular aspect. I guess I agree primarily with Professor Auerbach.

Chairman LAFALCE. That is what gives me most concern about the Treasury proposal.

Mr. AUERBACH. Sure.

Chairman LAFALCE. While I can agree with it in large part, I have certain specific problems such as elimination of the deductibility for State and local taxes—my chief concern is my uncertainty about the dislocative effect.

Mr. BEHRAVESH. I think that is where Professor Auerbach's suggestion of a fairly liberal phase-in period is the way I would suggest going with this particular plan.

Chairman LAFALCE. All right. Let me ask you this question now. We are considering this plan proposed by the President only because it is both reform and tax neutral, but suppose we were able to pour something down the President's throat, if you will, that would raise revenues.

Not raise taxes, but raise revenues, as I said, distinguishing between an increase in tax rates and elimination or reduction of tax expenditures. What would your thoughts be about adopting the Treasury tax plan with respect to the elimination or reduction of tax expenditures, but either not adopting or modifying in order to enhance revenues, those provisions which lower both individual income tax rates or corporate tax rates?

Mr. AUERBACH. I will speak to that. I think one of the things one should be careful of in considering partial adoption of the Treasury plan, and I am not against the idea in principle, is that the consideration of equity played a very big role in the design of the plan in such a way that pieces fit together; each is required in order for equity to be maintained.

For example, you mentioned——

Chairman LAFALCE. In order for equity to be achieved, as opposed to maintained, it might be necessary to address the inequities.

Mr. AUERBACH. Fine.

Chairman LAFALCE. That exists within the present system.

Mr. AUERBACH. I agree. As long as that is taken into account when only one of many proposals is adopted. Let me just cite an example. You mentioned the removal of State and local tax deductions. Now, if part of the quid pro quo there is the lower marginal rates and if you didn't reduce rates but left in the removal of the deduction for State and local taxes, that could have major equity effects. I don't know what they are. One would have to be careful in ascertaining what the equity effects would be of partial adoption of the Treasury Plan, leaving certain provisions in and certain provisions out.

But if that were done, then I don't think there would be anything wrong with it.

Chairman LAFALCE. Well, OK. Let's accept that, but let's go not just to the equitable question, but let's go to the economic question. What would be the economic impact of doing something like that in your judgment?

Mr. AUERBACH. Well, it depends on what you are going to leave in and take out.

Chairman LAFALCE. Well, suppose that we are accepting the Treasury tax plan insofar as its elimination and reduction of corporate tax expenditures are concerned. Suppose we do not go along with them or modify their reduction of individual corporate tax rates. I know you haven't studied this, so it is an off——

Mr. AUERBACH. The difficulty of analyzing the problem when you don't have the same amount of revenue being raised is that we know that, as any economist will tell you, taxes distort behavior, and higher tax rates distort behavior more. One can say with a fair amount of certainty, I think, that the system which you envision would be one with higher revenue, not higher rates, but higher revenue. It would probably be a better system in terms of economic efficiency than what you would get if you just put a surcharge on the current income tax today, because raising rates even higher would worsen distortions.

If we do decide to raise more revenue by not lowering rates and broadening the base, I think the efficiency gains are not going to be particularly big. They may not even be positive. On the other hand, given that you are raising more revenue, you are doing it in an efficient way. If it doesn't happen this year and it happens next year, it is merely an illusion to say that you have preserved economic efficiency by keeping taxes low because you have just done it temporarily.

Chairman LAFALCE. And you might only have an opportunity now. It would be very difficult to do it in a recession.

Mr. AUERBACH. Right.

Mr. FULLERTON. I tend to think that the Treasury plan is a well-defined coherent package which for a number of reasons perhaps might be best untampered with, simply——

Chairman LAFALCE. I understand that, but as my philosophy professor said when I asked what would you do if it was raining outside, don't tell me it is not raining outside. And my question is what do you think the effect would be economically, if we were to proceed as I suggested.

Mr. FULLERTON. I will answer that if you will allow me to finish the sentence.

Chairman LAFALCE. Fine, OK.

Mr. FULLERTON. Just the thought that once you start tampering with it, I think it invites everybody and their brothers to come along with their own pet project to come into the code. And that is what has been wrong with the Tax Code the past——

Chairman LAFALCE. That will happen.

Mr. FULLERTON. That will happen anyway.

Chairman LAFALCE. That will happen in the Ways and Means Committee. It might not on the floor of the House of Representatives, but it will happen in the Ways and Means Committee.

Mr. FULLERTON. The other aspect of that, too, is that I think that the NAM and DRI and, to some extent, Wharton have come around in their thinking with more time to look at the Treasury plan because they recognize it is a coherent package. And I think that if you undertook some of the ideas to broaden the base so as to get more revenue without lowering the rates, you would undo that emerging consensus and that you would get much more objections from the business community.

But that is it. I will try now to answer your question.

Chairman LAFALCE. Well, the question of whether we should proceed because of the consensus within the business community or whether we should proceed because it has economic merit are two different questions.

Mr. FULLERTON. I happen to think the Treasury plan has a lot of economic merit, and I actually would not like——

Chairman LAFALCE. I understand that, but I am sure you also believe reducing the deficit has a lot of economic merit.

Mr. FULLERTON. As I said earlier, I think one of the first——

Chairman LAFALCE. It would be wonderful if we could combine the two through certain trade-offs.

Mr. FULLERTON. I think the first item is to attack the big investment tax credit and accelerated allowances. I like the depreciation scheme in the Treasury plan or Bradley-Gephardt for that matter. Indexing, I think, is very important.

Chairman LAFALCE. Are you saying, then, Professor Fullerton, that if we could not take the total Treasury tax plan but just take the elimination of the investment tax credit and their changes in ACRS——

Mr. FULLERTON. Now, that would raise quite a bit more revenue.

Chairman LAFALCE. You would accept that even if we didn't reduce the individual corporate tax rates?

Mr. FULLERTON. If you needed that much revenue, yes.

Chairman LAFALCE. How much revenue? You said maybe about $30 billion with the investment tax credit. How much—do you have any idea, if we adopt the changes in ACRS?

Mr. FULLERTON. That is a problem because of the timing that Professor Auerbach mentioned earlier.

Chairman LAFALCE. Suppose we don't phase it in as he wants. Suppose we go to it.

Mr. FULLERTON. The problem with ACRS is that the deductions are front loaded. You get more early, less later. Changing to an RCRS would mean more early and less later. So revenue projections for the next 3 or 4 years are sort of misleading because they will get a lot less in the way of deductions the next few years, but more later. Because ACRS tries to track the actual wear and tear on the asset, most of which happens later, revenue would go up a lot in the next few years with RCRS because the deductions would not be so front loaded.

Chairman LAFALCE. They would come up when we need it most.

Mr. BEHRAVESH. I think the Treasury plan is a good plan, but it is not the only plan. I think we have to keep that in mind. I think there is scope for moving in the direction that the plan, the Treasury plan and some of the other tax reform plans are suggesting and also raise revenues. I could caution Congress not to exacerbate the existing distortions and to not do things that compound the kinds of problems that we now have with the existing Tax Code.

You can take the Treasury plan as a kind of menu that allows you to move in that direction, yet addressing the deficit issue at the same time. I do think there is room for that.

Chairman **LaFalce**. Congressman Shumway.

Mr. **Shumway**. Thank you, Mr. Chairman.

Mr. Fullerton, the AEI study indicates that in periods of declining inflation such as we are in now when the ACRS is combined with the investment tax credit, the net result is to transform the corporate income tax into a very large corporate subsidy. In some cases, the data reveals firms in effect are writing off more than 100 percent of the cost of their investments.

Is there any data available that would indicate what percentage do these firms constitute in relation to the total percentage of corporate America; that is, firms that can avail themselves of these provisions?

Mr. **Fullerton**. Yes, the book we just discussed earlier has, I think, a useful diagram in it that shows how much investment in the corporate sector is taxed at rates varying between 100 percent subsidy. I didn't bring it with me, but I had some numbers from it in my testimony. Specifically——

Chairman **LaFalce**. Would that diagram also show what percentage levels of investment these firms have made?

Mr. **Fullerton**. Yes. Well, the numbers that I took out of that diagram to bring with me indicate that 30 percent of current corporate investment is taxed at rates between 80 or 90 percent. In other words, a large bulk of corporate investment, 30 percent, is at rates that are very high, like 80 to 90 percent effective tax rates, while another approximately 30 percent are taxed at rates below zero.

In other words, subsidized.

Mr. **Auerbach**. If I could just jump in and clarify, Don is making a point about the assets that are receiving negative tax rates, which is not necessary the same as how many companies would be in a loss position. I think that would depend on the specific asset mix, how many are negatively taxed, how many positively, I believe in 1981 when the Safe Harbor leasing provisions were introduced, Treasury did some investigation into how many firms would have been in that situation had they not been able to avail themselves of safe harbor leasing.

Off hand, I can't remember what the figure was, but I think such statistics are available.

Mr. **Shumway**. Mr. Auerbach, some economists contend that ACRS and investment tax credit are necessary to equalize the taxation of income from labor and income from capital. They still are not as equitable as the tax proposal of writing off all investment in one year. What are your views on that kind of proposal?

Mr. **Auerbach**. Well, I know that there are people who favor that. I have never heard the argument that it would somehow reduce the lack of neutrality between labor and capital. Usual arguments in favor of expensing, at least the best economic arguments that I know of in favor of having a write-off of capital, involve what essentially would be a transition to using consumption or consumed income as a tax base rather than income. But it should be said, and it should be stressed, that a coherent proposal of that type would also include some form of elimination of the interest deduction at the corporate level.

But the Kemp-Kasten proposal would not do anything to the interest deduction. And people who——

Chairman **LaFalce**. That would just be the biggest give-away of the Federal Treasury that I have heard of.

Mr. **Auerbach**. Well, subject, of course, to the fact that losses aren't refundable. The people, not necessarily economists, would often make the argument that, say, having expensing yields zero tax and hence would have no distortion, often conveniently ignore the fact that that statement is only valid without the interest deduction.

With the interest deduction, you have a negative tax rate which can be just as distortionary as positive ones, but with the added problem that it doesn't raise as much revenue.

Mr. **Fullerton**. If I could elaborate on that, the way we do these effective tax rate studies, if you have economic depreciation allowance and no credit, for an equity financed investment, the effective rate is the statutory rate. If you sort of do things right, measure the income tax at the statutory rate. If you change that system to allow an interest deduction on a debt financed investment, the effective tax rate goes to zero because they deduct all that income in the form of interest payments. Or you get the effective tax rate to zero by expensing.

So either of those will reduce the effective tax rate from 46 percent to zero. If you do them both, it just sort of has to make it negative, and that is exactly what the Kemp-Kasten plan would propose.

Chairman **LaFalce**. Treasury doesn't do that, Bradley-Gephardt doesn't do that.

Mr. **Fullerton**. No, nor a consumption tax. A coherent consumed income tax would do one or the other, but not both.

Mr. **Shumway**. Mr. Behravesh, is business investment determined solely on the basis of tax preferences? What other factors are there in the company's investment decisions?

Mr. **Behravesh**. Well, there are plenty of other factors. The growth in sales, capacity utlization. Those are very important considerations in how and what a business decides to invest and how much.

Mr. **Shumway**. Thank you.

Chairman **LaFalce**. Mr. Wortley.

Mr. **Wortley**. Thank you, Mr. Chairman.

Although a late arrival, I don't want not be repetitious. Let me toss out a couple of questions What is your opinion of the impact of the elimination of capital gains tax as proposed in the Treasury proposal? What sort of effect will that have on capital formation?

Mr. **Auerbach**. My understanding of the Treasury estimates, that the switch from capital gains exclusion to capital gains indexing without exclusion would actually lose revenue in the sense that they think that on net, it is a slightly more favorable provision to people with capital gains than the current system. This obviously doesn't mean that that would be true for every investor.

It surely makes more sense, though, to have a system where only real capital gains are being taxed rather than having ad hoc correction for the fact that really not all of these gains are real, and some are simply caused by inflation. In that sense a more neutral treatment of capital gains certainly must be a good thing for people contemplating investments.

If one anticipates a return of high rates of inflation, I think that makes the Treasury proposal look very favorable compared to the current system. I also think it is worth pointing out that there has been a lot of concern over what the capital gains changes would do in those very specific areas where a lot of risk is being undertaken and very large returns are expected, if the project eventually succeeds.

We are talking about venture capital now. I know people in venture capital are worried about shifting to full taxation with real capital gains rather than partial taxation of nominal ones. This is as good a time as any to make a plug about tax expenditures as the chairman has already been doing.

If one really thinks venture capital is deserving of some sort of incentive, it seems to me that using the system of capital gains taxes is a singularly inefficient way of doing it because it must be true that 99 percent of the capital gains on which people pay taxes are not associated with owner managed, entrepreneurial enterprises or cases where there is limited ownership and larger shares in startup companies.

Certainly we are not talking about ownership in the Standard and Poor's 500 companies, when we talk about preserving incentives for venture capital.

Mr. WORTLEY. What would you think if you graduated the capital gains tax, gradual reduction. Maybe the second year the tax would drop to 10 percent, and by the third year, no capital gains tax. Does that make any sense in terms of keeping the capital invested over a period of time rather than jumping in and out?

Mr. AUERBACH. You mean instead of having a short-term, long-term distinction, have a long-term phase out?

Mr. WORTLEY. Yes, with ultimate elimination.

Chairman LAFALCE. Increase the inefficiency——

Mr. AUERBACH. It would do a couple things. Depending on how long it would take to phase it out, you would worsen the lock in effect during the period when the tax rate would be declining. If you have a decline over a fairly short number of years, it would seem to me it would certainly increase the incentive to invest. But there is an additional problem, which is the ability of people to convert income from one form to another.

One of the arguments in favor of Treasury or Bradley-Gephardt, which tax capital gains and ordinary income at the same rate, has nothing whatsoever to do with investment incentives, but tax avoidance. Tax lawyers are very good at instructing people how to convert one form of income to another, and one of the problems of the current system is that capital gains are taxed at a different rate.

If you make that rate zero, that certainly will make the incentive to convert things into capital gains that much greater. It will put additional pressure on the people who write the tax laws to put in sufficient safeguards to prevent that sort of thing from happening.

Mr. FULLERTON. I have two general comments on the capital gains taxation issue that you are raising. One is that the 60-percent exclusion, formerly 50-percent exclusion, was designed originally as an ad hoc offset for the ravages of inflation. And one of the great advantages I think of the coherent package in the Treasury proposal is that it proposes to deal comprehensively and correctly with inflation.

That is, it proposes to index capital gains. I don't think that in periods of high inflation, particularly variable inflation, that the ad hoc correction for it is adequate. They have taken the same approach with things like depreciation and said let's not accelerate depreciation as an ad hoc offset to inflation. Let's keep economic depreciation allowances, but index them so if inflation is high, deductions are lower. If inflation is lower, deductions are higher. The same with capital gains. If inflation is high, we don't want to tax nominal capital gains at all. The price is simply going up, it is not a real capital gain unless the price of the asset goes up higher than the rate of inflation.

The second basic point about capital gains taxation that I would like to make is simply that there is a fundamental choice, well exemplified by the Treasury plan, between having an income tax and having a consumption tax. There has been a lot of discussion over the past few years of consumption tax and expensing of assets with no interest deductibility as a comprehensive consumption tax, but that seems to have fallen a bit by the boards.

Everything on the table now or the major proposals on the table now, are modified flat income taxes. And if you make that philosophical choice for an income tax instead of a consumption tax, it calls for taxing comprehensively real capital gains in a fashion consistent with other real income. If you opted for a consumption tax, you would say don't tax capital gains at all, only when the income is consumed.

If you want an income tax, then measure income properly and tax the real capital gain fully.

Mr. WORTLEY. We hear the argument from time to time about either eliminating the corporate tax or tax on dividends. What effect would you see that having on the overall output of capital formation? How about all three of you giving a shot at that one?

Mr. FULLERTON. I will go first. One of the aspects of the research that I quoted earlier is that effective tax rates up to 100 percent and down to minus 100 percent are distortions inherent in the corporate income tax system where the overall rate of corporate tax given not only the investment tax credits and accelerated depreciation deductions, but interest deductions as well, is about zero or a net subsidy.

Professor Auerbach quoted numbers earlier that the corporate taxes as a fraction of Federal revenue has fallen to 6 percent. New investments are being subsidized, so that might be expected to fall even further. I think we are left with a broad picture here of a corporate tax that has wide distortions in the use of assets and is not really getting us any revenue.

The point of having a tax is to collect revenue. It is generating almost no revenue and is simply distorting investment. So eliminating it, or, as the Treasury plan proposes, measuring correctly the real income adjusted for inflation and taxing it, would either remove the distortions and not be that much worse off in terms of revenue, or eliminate the distortions and make it into a real tax.

Mr. **Behravesh.** Let me jump in here, and I will try to answer both of your questions because I really didn't answer the first one. One of the great things I think about this particular plan is that it really does address fair and square the distortions in the tax system. Both gentlemen here have addressed those. I won't repeat them. So I think from that point of view, both the capital gains treatment, indexation, and the way they are dealing with the corporate taxation issue is the correct philosophy.

As a footnote, I might add one thing that you can expect from tax lawyers—and we seem to be badmouthing tax lawyers here—is if you remove or eliminate the corporate tax rates or eliminate corporate taxes entirely, then you can count on the fact that more and more people are going to transact as corporations in order to avoid taxes.

So you may be compounding a tax avoidance problem. So that is something you have to think about. I don't know how big an effect that has, but it clearly is something that might encourage that kind of behavior. It is clearly something to keep in mind.

Mr. **Auerbach.** I think that point is very important. Some people view the corporate tax largely as something to stop people from accumulating within the corporation. But leaving that issue aside for the moment, I would argue that both removal of the corporate tax and removal of the tax on dividends are singularly inefficient ways of reducing taxes, because while they would reduce tax collections, they would have a pretty minimal effect on the overall incentive to invest.

The one gain we would see would be the removed distortion in the interasset allocation of capital. The reason for the ineffectiveness is the same in both cases. I alluded earlier in my testimony to the fact that a reduction in the corporate tax rate, while it might have a beneficial effect on new investment, would have the same effect on income generated from existing sources owned by the corporations already. Lowering the tax rate would generate certain windfalls that might be avoided by phasing in tax rate deductions.

If that is true of reducing the tax rate, it is certainly true in spades of reducing the tax rate to zero. In the case of removing dividend taxes, I think one has to distinguish between the sources of equity finance. People can make the argument that dividends are doubly taxed because of the corporate level income tax and dividend tax.

First one has to be aware of whether the corporate tax is operative. Even if it is, I think this point is largely valid only when one considers additional equity investment. Most corporations aren't in the business of doing very much of that; that is, they are generating funds for which entirely different rules hold. If the money is not coming out of the investors' pockets, but is retained by corporations, there is an avoidance of a dividend tax today.

Instead of being a dividend reinvestment plan where the dividend is paid out, the people pay taxes and send the money back to the corporation, the whole round trip gets avoided. In the process so does the tax on the dividends that are received. That incentive roughly offsets the double tax on future dividends. If one wanted to consider removing this disincentive, probably the most efficient way to do it would be to try to tailor a program aimed more at startup companies, companies expanding through increases in their equity base.

I think I would also level this criticism at the Treasury dividends paid deduction; that a more efficient way of achieving the same objective could have been done through something that would exclude certain firms from participating in that deduction.

Mr. **WORTLEY**. Thank you, Mr. Chairman.

Chairman **LAFALCE**. Thank you.

Just a few more questions. Assume we get caught up amongst the arguments of the various special interest groups and they say there has to be a considerably longer gestation period for such major tax reform. And we are unable to come up with a yes or no vote on the Treasury plan, the Treasury plan revested or Bradley-Gephardt, what have you. And we do say we have to increase revenues.

What about if we just use an across-the-board reduction of corporate tax expenditures, not the elimination, but just say we will reduce by 10 percent after tax expenditure for at least fiscal year 1986 or whatever.

Mr. **AUERBACH**. Would you take special analysis G and just go down the list? Would it be all tax expenditures?

Chairman **LAFALCE**. I could ask the question both ways.

Mr. **AUERBACH**. The only problem I see with that, here perhaps I am overstepping——

Chairman **LAFALCE**. I am thinking of raising revenues now.

Mr. **AUERBACH**. Then whether one gets included in the tax expenditure budget or not is a very important consideration.

Chairman **LAFALCE**. Yes.

Mr. **AUERBACH**. I know there has been question and debate in the early years of the current administration about what a tax expenditure was. In 1981, the decision was made not to treat ACRS preferences as tax expenditures.

Chairman **LAFALCE**. Is ACRS not considered a tax expenditure?

Mr. **AUERBACH**. I think it was not in 1981. Certain ardent opponents of tax expenditures in the Treasury at the time argued correctly, although in the case it wasn't necessarily appropriate, that what a tax expenditure is depends on what you think the appropriate tax base is. If you think the appropriate tax base is a zero tax on corporations, then any possible tax is a negative tax expenditure.

There is a certain element of truth in the sense that what constitutes a perfect tax system is largely subjective. There are certain things everybody seems to be able to agree are tax expenditures and other things people seem to have more difficulty agreeing on. I would guess you might start out with a uniform reduction in tax expenditures and end up with a very nonuniform reduction, which would make it less attractive.

Chairman LaFalce. Mr. Fullerton. Mr. Behravesh.

Mr. Behravesh. Well, I think that kind of an across-the-board scheme, if you will permit me, is kind of arbitrary because I think there are particular provisions which I would like to see, attacked first before you go through——

Chairman LaFalce. Some would argue it is not arbitrary because we can't make selective decisions which would be arbitrary. We will just do it across the board.

Mr. Behravesh. I think, though, some of the provisions being discussed are worse villains than others in some sense.

Chairman LaFalce. Yes.

Mr. Behravesh. I would attack the problems rather than to try the even-handed approach.

Chairman LaFalce. I would take the approach you suggest. But suppose that we are unable to come up with decisions involving hard choices. Do you think that that would be an acceptable way of proceeding, if not a preferable way?

Mr. Behravesh. I would feel uncomfortable, yes.

Chairman LaFalce. Professor Fullerton.

Mr. Fullerton. It is not the worst idea I have heard, subject to the administrative problems that Professor Auerbach just described, but it just seems that with so much similarity between the things like the Treasury plan and Bradley–Gephardt now on the table, that we would be missing a terrific opportunity for more fundamental reform; that seems a bit like a band-aid solution on the order of what has gone on for many, many years.

Chairman LaFalce. Sure. I agree with you. One last question. Professor Auerbach, you mentioned that the investment which has come about due to the 1981 tax laws really haven't done that much insofar as real investment is concerned. You say it is basically the same now as it was in 1979.

Mr. Auerbach. As a percentage of the GNP?

Chairman LaFalce. As a percentage of GNP.

Mr. Auerbach. Yes.

Chairman LaFalce. What type of investment were you talking about?

Mr. Auerbach. Business fixed investment.

Chairman LaFalce. As opposed to?

Mr. Auerbach. Housing, inventory investment, primarily the others.

Chairman LaFalce. Would you gentlemen share that analysis?

Mr. Auerbach. That number was taken out of the Economic Report of the President.

Mr. Behravesh. I think Mr. Auerbach is right, but I think there has been a shift in the mix in growth rates between structures and equipment where ACRS really favors equipment, so you see much faster growth in equipment than structures due to ACRS. So you have to add that point, too.

Chairman LaFalce. Anything you would like to add, Mr. Fullerton?

Mr. Fullerton. No, that sounds good.

Chairman LaFalce. Mr. Wortley.

Mr. WORTLEY. I rather expect we are going to be deadlocked on this tax reform issue this year. And maybe we will just revert to the so-called fine-tuning. My own personal opinion is that the existing Tax Code has helped to generate a rather healthy and obvious recovery in this country and there can't really be all that many things wrong with it.

But if we were fine-tuning the Tax Code, what areas do you think we could eliminate there without having a disastrous effect upon capital formation and continuing economic recovery, leasing type of things and so on, or what? Personally, I think it is immoral. General Electric happens to be one of my biggest corporate constituents, but whether they can go out and make that many billions of dollars and not pay any taxes——

Mr. AUERBACH. I have done a litle bit of work on leasing, so let me answer that. I think you are probably being somewhat unfair to General Electric. I hold no brief for them or their opponents, but there is a study of the tax leasing under Safe Harbor Leasing. The Treasury did in 1983, I believe, a public study. They found the transfer of tax benefits under Safe Harbor Leasing was quite efficient in the sense that while it was true that companies—General Electric is probably the best known of them—were purchasing enormous amounts of tax benefits and using them to offset their current and previous year's tax liability, they were paying for them.

They were paying a very large fraction of the full value of the benefits. When one takes account of the risk that was involved and the transaction costs that were involved, the conclusion of the Treasury study was that if one wanted to provide comparable investment incentives for companies that didn't have taxable incomes and companies that did, then this was actually a pretty effective way of doing it.

Unfortunately, what it highlighted was the problem of having a viable tax system when many companies have a negative tax. But that is more a criticism of the ACRS being in place than it is of the leasing provision. I think that really is the problem; leasing is merely a result of what we did to the corporate tax in 1981 and shouldn't be seen as the primary villain.

Mr. FULLERTON. If I could address a slightly different aspect of your question, I think the apparent success of the 1981 tax provisions is related to the stronger performance of the macro economy in recent years. I think it is undisputable that the economy is doing well now in a macro sense; that there is more investment and more employment. But most of the aspects we have been emphasizing here really don't have anything to do with the macroeconomy or whether there is greater total stock of capital or greater amount of employment.

Rather, for a given stock of capital and a given level of employment, is there any way we can rearrange things so as to produce more. It is much less of a tangible idea. It is not so tangible as putting people to work and having more tangible physical equipment and structures there, but it is a much more conceptual problem.

That is, we take a given set of equipment and structures and a given labor force and just switch things around until we get stuff that is of more value. And it is that kind of estimate that is provided in this study we were discussing; the total value of national output could be increased by something like 1 percent or a one-time wealth effect of $400 billion.

In that sense, it is hard to tell from looking at the economy that it is not doing so well because you can't see that kind of loss. You don't see the unemployment or capital being in the wrong place, but it is nonetheless still there, and this is an estimate of how much better the economy would be working, a good macro economy and full employment, and how much better off we would be with things rearranged a bit.

That is, I think, the major problem with the current system.

Mr. **Behravesh**. Let me address an even slightly different aspect. If I understand your question to be how can we—and I may have misinterpreted it here, but how can we tighten up the code without doing some severe problems.

Mr. **Wortley**. That's right. That is the question.

Mr. **Behravesh**. I think there are lots of small provisions directed at specific industries that somebody decided to tuck into the various bills. There are lots of those you could ferret out and get rid of. I would effect a particular industry that has been favored. But it would remove some of those distortions and not create the kind of problems you are concerned about.

Chairman **LaFalce**. If I may proffer an answer, but only because I asked a similar question. I targeted in on the investment tax credit, Mr. Wortley, and I think just about everybody said if you had to eliminate any one provision of the tax code in order to raise revenues, the investment tax credit would be No. 1 or near the top of the list.

If you would like to join with me, Mr. Wortley, I would really appreciate your bipartisan support.

Gentlemen, let that be the last comment. Thank you.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[The following study and paper was submitted by Mr. Auerbach for inclusion in the record:]

The Fair Tax Act and Corporate Investment: An Evaluation of the Bradley-Gephardt Proposal

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1. Introduction

This paper considers the economic impact that implementation of the Bradley-Gephardt tax proposal, also known as the Fair Tax Act, would have on the allocation of fixed capital and the incentives for new investment in the United States. The focus here is primarily on corporate behavior and the changes that would affect corporate investment decisions.

The Bradley-Gephardt proposal (hereafter referred to as BG) would involve comprehensive changes in both the individual and corporate income taxes, with the overall objectives of lowering marginal tax rates, broadening the tax base and simplifying the tax system. Its relevant provisions are described in greater detail in the next section.

Among the specific questions this study seeks to answer are:

1) What would be the loss in economic efficiency caused by the misallocation of corporate fixed capital under the proposed plan, compared to historical and current levels?

2) As measured by effective marginal tax rates on new investment, how would incentives under BG compare to those that currently exist and have prevailed historically?

3) How sensitive will the degree of distortion and overall effective tax rate be to the rate of inflation under BG? How does this sensitivity compare to that of the current tax system?

4) To what extent would the tax changes proposed by BG, if enacted immediately, result in windfall gains or losses to owners of existing capital assets?

5) How would schemes that would phase in the BG proposal influence the magnitude of such windfalls? What would a phase-in do to the effective rates of tax during the transition?

To answer these questions, I use various models of corporate behavior, described in more detail below. The findings suggest that a move to BG would reduce the economic loss due to the misallocation of corporate capital to a level lower than any attained during the past three decades. At the same time, the overall effective tax rate on new investment would rise somewhat, given projected rates of inflation, to a level very close to the proposed statutory corporate rate of 30 percent. Changes in the inflation rate would alter these results but to a lesser extent than would be so under the current tax system.

Immediate introduction of BG would result in a decline in future tax liabilities of owners of existing capital assets, because of the reduction in the statutory corporate income tax rate. This windfall gain could be lessened by a gradual phase-in of the rate reduction. A phase-in of this type could actually stimulate investment during the transition if investors believed that the announced rate reductions actually would take effect.

2. The Fair Tax Program

The Bradley-Gephardt proposal, as outlined in the "Fair Tax Act of 1983," would reduce the maximum marginal statutory rates of tax on both individual and corporate incomes to 30 percent, from the current levels of 50 percent and 46 percent, respectively. It would attempt to maintain revenues at current levels through numerous base-broadening measures. Among such measures would be the inclusion of all (rather than 40 percent of) long-term capital gains in the individual tax base, the taxation of all corporate income at the maximum rate, the repeal of the investment tax credit, the replacement of the Accelerated Cost Recovery System (ACRS) introduced in 1981 with an alternative depreciation system based more closely on economic asset lives, and modification of the treatment of costs in extractive industries. The last two of these changes are now discussed further.

A. Depreciation Under the Fair Tax Program

Under ACRS, assets outside of public utilities and extractive industries fall primarily into three depreciation classes: light equipment, equipment and structures. Assets in these classes can be written off, for tax purposes, over three, five, and eighteen years, respectively. Assets in the three- and five-year classes also receive an investment tax credit of six or ten percent, respectively, subject (since 1982) to a 50 percent adjustment of the depreciable basis for the amount of the credit received.

The pattern of depreciation over tax lifetime is specified in the 1981 legislation for the three-year and five-year equipment classes, approximating those deductions that would be taken using the 150 percent declining balance method with a switch-over to straight line, with a half-year convention applied to the first year's deductions. For structures, the investor may use the 175 percent declining balance method with switch-over to straight line.[1] Despite the apparent simplicity of having only three depreciation classes and specified deduction patterns, complexity remains because of the existence of other, special classes for particular types of assets, such as low income housing and public utility structures, and because of the recapture treatment of used asset sales.

Numerous studies of the economic impact of ACRS[2] have found that it substantially lowered the effective rates of tax on new corporate investment beyond those rates existing under the Asset Depreciation Range (ADR) system that prevailed during the period 1971 - 1980.

Under BG, changes would be made in the number of depreciation classes, the lifetimes over which assets could be written off, the pattern of allowances over these lifetimes, and the tax treatment of used asset sales. In addition, as noted above, the investment tax credit would be repealed.

There would be six equipment classes, with tax lifetimes of four, six, ten, eighteen, twenty-eight and forty years, respectively. Assignment of assets to these classes would be based on economic lifetimes, as measured by the midpoint lifetimes specified by the ADR system. This assignment pattern is shown in Table 1. All structures would be assigned to the last depreciation category, with a tax lifetime of forty years.

Compared to ACRS, these lifetimes are longer for most assets, substantially so in many cases. However, all assets would receive an increase in the rate of depreciation over these extended lives, to 250 percent declining balance with the half-year convention used to determine first-year allowances. Hence, whether a particular asset would gain or lose in a switch to BG is uncertain, although, as shown below, equipment would face higher effective tax rates and most types of structures would face lower tax rates than under the current tax system. This relative shift in the tax burden from structures to equipment would be largely due to the proposed repeal of the investment tax credit.

Under ACRS, investors must keep track of individual asset bases in order to determine depreciation allowances as well as to calculate taxes due if a particular asset is resold. Under BG each asset would receive a deduction each year equal to a constant fraction (2.5 divided by its class life) of its remaining basis; therefore, bases of assets in each class may be added and the same constant fraction applied each year to this sum. This is what is proposed: investors would establish six open-ended accounts (one for each asset class) adding the cost of acquired assets and deducting amounts realized

Table 1

Asset Depreciation under Bradley-Gephardt

ADR Midpoint Life (Years)	BG Life(Years)
less than 5	4
5 - 8.5	6
9 - 14.5	10
15 - 24	18
25 - 35	28
over 35	40

from the sale of assets. This latter provision would replace the current treatment of used-asset sales, and could cause a seller to deduct from its depreciable basis an amount exactly equal to the added basis obtained by the asset's buyer. Hence, current incentives to resell certain assets in order to reduce the net combined tax liability of buyer and seller would be reduced.

B. The Treatment of Extractive Industries

Under current tax law, very complicated special tax provisions apply to costs incurred in extractive industries (i.e., oil and gas and mining) through lease acquisition, exploration and construction. In particular, mining development costs and intangible drilling costs are either expensed immediately or written off over a very short period, while leasing and drilling costs are subject to a variety of provisions for cost depletion, percentage depletion and recapture.

Under BG, these costs would all be included in one of the six established asset classes. For oil and gas, costs would be put into the ten-year class. For mining, the class assignment would be determined using the mine's estimated useful life, according to the schedule presented in Table 1.

3. Data

In order to consider the impact of BG on investment behavior and capital allocation, it is necessary to consider the impact of the proposed legislation on several different types of investments. We consider thirty-four different categories of fixed assets that together account for all fixed capital in the United States.[3]

Shown in Table 2 are category names for each of these thirty-four asset types, along with ADR midpoint lives, ACRS lives, and BG lives for each type. Categories 1-20 are equipment, and categories 21-34 are structures. Because of the aggregation of a much larger number of distinct ADR classes into these twenty equipment classes, all of these classes have an average midpoint life that leads to placement in the four, six, ten or eighteen year BG asset class. Category 33, extractive industry structures, presents a special problem because it includes assets receiving widely varying tax treatment under ACRS. The estimate of a five-year write-off is intended as a rough average of the general expensing of intangible drilling costs and the longer write-off of costs not qualifying for such treatment. The use of a ten-year lifetime under BG is exactly as specified for oil and gas. I assume the same lifetime for mines as well, and hence for the category as a whole.

In addition to data on tax lifetime, information on capital stock composition, by industry and in the aggregate, and rates of true economic depreciation is utilized in the calculations. These data and their sources are described in Appendix A.

4. Basic Results

The approach used below to measure the incentive to invest in a particular type of asset involves the calculation of an "effective" tax rate for that asset under the particular tax system and economic conditions assumed. The effective tax rate is defined to be that tax rate on actual economic income which, if imposed in place of the actual tax system, would leave the investor with the same after-tax rate of return. For example, an asset receiving very generous depreciation allowances and an investment tax credit under ACRS may cause its corporate owner to pay very little additional tax over the asset's lifetime, even at the current 46 percent tax rate, because the tax base is much narrower than true economic income. Another way of expressing this

Table 2

Asset Types and their Tax Lifetimes

Asset Class	ADR Midpoint Lifetime	ACRS Lifetime	BG Lifetime
1. Furniture and fixtures	10.0	5	10
2. Fabricated metal products	12.5	5	10
3. Engines and turbines	15.6	5	18
4. Tractors	4.3	5	4
5. Agricultural machinery	10.0	5	10
6. Construction machinery	9.9	5	10
7. Mining and oilfield machinery	9.6	5	10
8. Metalworking machinery	12.7	5	10
9. Special industry machinery	12.7	5	10
10. General industrial machinery	12.3	5	10
11. Office and computing machinery	10.0	5	10
12. Service industry machinery	10.3	5	10
13. Electrical equipment	12.4	5	10
14. Trucks, buses, and trailers	5.6	5	6
15. Autos	3.0	3	4
16. Aircraft	6.3	5	6
17. Ships and boats	18.0	5	18
18. Railroad equipment	15.0	5	18
19. Instruments	10.6	5	10
20. Other equipment	10.2	5	10
21. Industrial buildings	28.8	15	40
22. Commercial buildings	47.6	15	40
23. Religious buildings	48.0	15	40
24. Educational buildings	48.0	15	40
25. Hospitals	48.0	15	40
26. Other nonfarm buildings	30.9	15	40
27. Railroads	30.0	15	40
28. Telephone and telegraph	27.0	15	40
29. Electric light and power	27.0	15	40
30. Gas	24.0	10	40
31. Other public utilities	22.0	10	40
32. Farm structures	25.0	15	40
33. Mining, shafts, and wells	6.8	5	10
34. Other nonresidential structures	28.2	15	40

result is that the effective income tax rate on this asset is much lower than 46 percent. Indeed, one would expect effective tax rates under BG to be much closer to the statutory rate than is presently the case, because of the proposed broadening of the tax base through the lengthening of asset lifetimes and repeal of the investment tax credit.

The actual methodology used assumes corporate investors require a real net return of four percent, after corporate taxes, and that they project inflation based on past experience. Further details concerning the calculations are given in Appendix B.

The effective tax rates for each of the thirty-four asset types shown in Table 2 are shown in Table 3 for the years 1984 and 1985, assuming that BG is in effect in 1985. For the sake of comparison, I assume that investors expect the inflation rate to remain permanently at its 1983 level of 4.2 percent.

The results are very easily summarized. In 1984, all types of equipment face negative tax rates. Despite the introduction of the partial basis adjustment for the investment tax credit at the end of 1982, these negative rates indicate that, given the currently low level of inflation, the present value of the investment tax credit and tax savings from depreciation allowances together exceed the value of immediate expensing of investment. For non-utility structures outside of extractive industries, however, rates vary from 33.7 percent to 42.5 percent. A switch to BG would raise effective tax rates on all types of equipment and on utility structures (categories 27-31) and lower rates on other structures. Overall, effective tax rates would vary between 14.8 percent and 42.1 percent, versus the current spread of -28.9 percent to 42.5 percent. In the aggregate, the effective tax rate would rise noticeably, from the current 19.4 percent to 28.4 percent.

Calculations by industry based on the figures in table 3 are presented in

Table 3

Effective Tax Rates
(percent)

Asset Class	1984 (current law)	1985 (Bradley-Gephardt)
1. Furniture and fixtures	-9.1	25.8
2. Fabricated metal products	-7.9	23.4
3. Engines and turbines	-7.1	30.1
4. Tractors	-12.7	14.8
5. Agricultural machinery	-8.2	24.1
6. Construction machinery	-13.4	33.0
7. Mining and oilfield machinery	-12.9	32.3
8. Metalworking machinery	-9.9	27.4
9. Special industrial machinery	-8.6	24.9
10. General industrial machinery	-9.9	27.4
11. Office and computing machinery	-21.0	42.1
12. Service industry machinery	-12.9	32.3
13. Electrical equipment	-9.6	26.8
14. Trucks, buses, and trailers	-19.5	29.1
15. Autos	-28.9	24.2
16. Aircraft	-14.2	23.8
17. Ships and boats	-6.8	29.9
18. Railroad equipment	-6.3	28.2
19. Instruments	-11.6	30.3
20. Other equipment	-11.6	30.3
21. Industrial buildings	39.7	31.0
22. Commercial buildings	35.9	27.6
23. Religious buildings	33.7	25.8
24. Educational buildings	33.7	25.8
25. Hospitals	35.4	27.2
26. Other nonfarm buildings	42.5	33.5
27. Railroads	22.6	25.4
28. Telephone and telegraph	27.1	30.2
29. Electric light and power	26.2	29.2
30. Gas 12.2	29.2	
31. Other public utilities	14.4	33.4
32. Farm structures	35.5	27.3
33. Mining, shafts, and wells	22.2	18.3
34. Other nonresidential structures	37.4	28.9
Aggregate	19.4	28.4

Table 4. These industry categories correspond to those used in preparing the national income accounts, except that categories 38-40 are combined there into a single category. Based on estimated weights of different types of capital used in each industry, these numbers in Table 5 are industry wide effective tax rates. Under current law, six industries face negative tax rates on their new capital investment, with other industries facing positive tax rates as high as 37.1 percent. Under Bradley-Gephardt, the range in tax rates would be reduced, with a low of 23.2 percent and a high of 33.1 percent. Thirty-six of the forty-four industries would have effective tax rates between 28 percent and 32 percent.

These results indicate that a shift to BG from the current system would increase the overall effective tax rate facing new capital investments while at the same time greatly narrowing the gap in effective tax rates among industries and assets. This narrowing can be expected to lead to an improved allocation of the corporate capital stock.

When effective corporate tax rates differ, corporate investors are encouraged to invest relatively more in lightly taxed assets than would be socially desirable. That is, investors might forego a potential investment with a high, before-tax rate of return because its after-tax return fell short of that on a lightly taxed investment with a lower before-tax return. For example, suppose an investor is choosing between industrial machinery, taxed currently at -9.9 percent, and industrial buildings, taxed at 39.7 percent. Suppose the former offers a real, before-tax return of 4 percent. Then the latter would need a before-tax return of 6.7 percent for it to be as attractive to the investor. While the investor's own optimal decision may be to choose the equipment, the return to society would be greater if the other choice were made as long as the before-tax return to the investment in

Table 4

Effective Tax Rates, by Industry, 1984-5
(percent)

Industry Number	1984 (current law)	1985 (Bradley-Gephardt)
1. Food and kindred products	23.8	29.4
2. Tobacco manufacturers	20.3	29.2
3. Textile mill products	19.1	28.0
4. Apparel and other fabricated textile products	21.8	29.3
5. Paper and allied products	12.4	27.6
6. Printing, publishing, and allied industries	25.8	29.2
7. Chemicals and allied products	14.9	28.2
8. Petroleum and coal products	31.3	30.0
9. Rubber and miscellaneous plastic products	13.8	28.7
10. Leather and leather products	25.0	28.7
11. Lumber and wood products, except furniture	20.9	28.8
12. Furniture and fixtures	26.1	29.5
13. Stone, clay, and glass products	20.2	29.1
14. Primary metal industries	23.1	29.3
15. Fabricated metal industries	18.7	29.4
16. Machinery except electrical	20.1	30.1
17. Electrical machinery, equipment and supplies	20.5	29.8
18. Transportation equipment, except motor vehicles and ordinance	27.9	29.9
19. Motor vehicles, and motor vehicle equipment	14.8	29.8
20. Professional photographic equipment and watches	23.2	30.7
21. Miscellaneous manufacturing industries	21.9	30.0
22. Agricultural production	7.8	24.2
23. Agricultural services, horticultural services, forestry and fisheries	3.5	23.8
24. Metal mining	32.1	30.8
25. Coal mining	8.8	31.3
26. Crude petroleum and natural gas extraction	28.5	23.2
27. Nonmetallic mining and quarrying, except fuel	1.0	31.5
28. Construction	-5.6	31.8
29. Railroads and railway express service	9.3	26.9
30. Street railway, bus lines, and taxicab service	-20.2	26.9

Table 4 (continued)

Industry Number	1984 (current law)	1985 (Bradley-Gephardt)
31. Trucking service, warehousing, and storage	-13.8	29.0
32. Water transportation	-6.4	29.9
33. Air transportation	-12.7	24.0
34. Pipelines, except natural gas	13.4	33.1
35. Services incidental to transportation	-0.1	29.2
36. Telephone, telegraph, and miscellaneous communication services	12.9	28.7
37. Radio broadcasting and television	23.3	29.4
38. Electric utilities	20.7	29.0
39. Gas utilities	11.6	29.2
40. Water supply, sanitary services, and other utilities	37.1	28.9
41. Wholesale trade	8.3	28.6
42. Retail trade	23.5	28.1
43. Finance, insurance, and real estate	34.9	28.1
44. Services	18.4	28.6

structures exceeded 4 percent.

Narrowing the range of effective tax rates should lessen this distortion in investment behavior and its social cost. One way of measuring this cost is to ask how much of the existing capital stock is being wasted due to this type of misallocation. Put another way, how much of the capital stock could we "throw away" and still produce the output actually being produced if the remaining capital stock were allocated efficiently? Using a methodology developed in Auerbach (1983a) and described in Appendix C, I find that the current level of capital stock wastage in the corporate sector is 3.25 percent, which is high by historical standards but lower than was the case in 1982 before the passage of that year's tax act (TEFRA). A move to BG would lower this measure to an estimated 0.10 percent of the capital stock, which is far lower than the value for any year since 1953, when these calculations begin. Given the estimates of the fixed corporate capital stock and the before-tax return to corporate capital, the implied reduction in this distortion would be equivalent to an annual increase in GNP of approximately 5.8 billion dollars per year.[4]

All of the results in this section are dependent on the economic assumptions made. One that is important is the assumed inflation rate. Because neither the current tax system nor the one proposed by BG is indexed for inflation, increases in the inflation rate will, through a decline in the real value of depreciation allowances, raise the effective tax rate. Opposite effects would occur if the inflation rate declined. Shown in Table 5 are the overall effective tax rates and percent of capital stock wastage for current law and BG under three assumptions: that inflation equals its 1983 level of 4.2 percent, that it is two percentage points lower, and that it is two percentage points higher. As can be readily seen, both calculations are more

Table 5

The Sensitivity of Tax Rates to Inflation
(percent)

	Aggregate Effective Tax rate		Capital Stock Wastage	
Inflation rate	1984 (current law)	1985 (BG)	1984 (current law)	1985 (BG)
4.2 (1983 level)	19.4	28.4	3.25	0.10
6.2	24.8	30.8	2.45	0.13
2.2	12.3	25.2	4.52	0.09

sensitive under the current tax system than under BG. This is due to the fact that depreciation allowances under BG represent a smaller component of the total, after-tax rate of return.

5. Windfalls, Phase-ins and the Transition

Despite its reduction in the dispersion of effective tax rates across assets, the BG proposal would increase the overall effective tax rate on corporate capital, raising the possibility that the distortion in the allocation of capital between the corporate sector as a whole and other sectors (particularly housing) will be worsened. Before considering this issue, however, it is useful to understand how a proposal that is aimed at maintaining roughly at current levels revenues from the corporate tax can lead to an increase in tax rates on new investment. The answer lies in the treatment of income from existing capital, which under a switch to BG would enjoy a windfall gain, being taxed at 30 percent instead of 46 percent. This tax reduction would have essentially no impact on new investment, but it reduces overall revenue nonetheless. This revenue loss can only be recouped through the higher marginal tax rates discovered above.

A way of expressing the magnitude of this windfall is in terms of what a shift to BG would do to the market value of existing corporate fixed capital. Assets which are identical in terms of their productive characteristics may, nevertheless, be valued differently because of the tax treatment they receive. Under the present tax system, for example, a five year old piece of equipment will be worth less to its owner than a new one, even after adjustment for differences in productivity, because, though it carries no further depreciation deductions or investment tax credits, its gross income is taxed at the same statutory rate. BG lessens this impact in two ways. By lowering the corporate tax rate, it makes the value of depreciation deductions received by the new asset worth less. By removing the investment tax credit and reducing the level of the depreciation allowances themselves, it further decreases the tax advantage of new assets over old.

Based on the historical tax treatment accorded different vintages of assets, it is possible to calculate the extent to which the market value of the existing corporate capital stock will be less than the market value of comparable new assets, because of this differential treatment. Using this method (described in Appendix D), I find that the fixed corporate capital stock in 1984 should be worth 33.6 percent less than if the same capital goods received the tax treatment of new assets. A switch to BC in 1985 would cause this discount to decline to 15.5 percent of the capital stock, representing a windfall of roughly 416 billion dollars.[5] This windfall equals the one time revenue "leakage" to existing assets that would be made up over time under BC by its higher tax rates on new investments.

An alternative exists, however, which would preserve the low statutory rate and depreciation structure of BC without the same windfalls. Instead of an immediate drop in the corporate tax rate, BC could be phased in, with the switch in depreciation schedules made immediately but the corporate tax rate allowed to decline gradually. This would, obviously, increase revenue. At the same time, however, it would not necessarily raise marginal effective tax rates during the transition. Here, one must distinguish between the effect of a permanently higher statutory rate and one that is higher only temporarily. Clearly, effective tax rates under an amended version of BC with a permanent rate of, say, 46 percent, would be several percentage points higher than the rates derived above for the present BC proposal. A version under which rates start out at 46 percent and decline over a brief period to 30 percent would not only limit the increase in the effective tax rate, but could actually lower it. This is because, in the early years after an asset is purchased, its cash flows are unlikely to exceed the tax shield offered by its depreciation deductions. This is the case even under BG. Hence, an increase in the statutory tax rate above 30 percent for these early years represents a higher rate at which short-term losses generated by new investments may be deducted against income from existing assets. This decreases the lifetime tax liability associated with new investments, thereby lowering their effective tax rates. This can occur despite an increase in revenue, because it is income from existing assets that is bearing the heavier tax.[6]

This result is demonstrated in Table 6, which shows the projected overall effective tax rates for the years 1985-1990 under three alternative versions of BG: an immediate cut in the corporate rate to 30 percent, a cut of four percent per year beginning in 1986 and ending in 1989 and an increase of four percent (to 50 percent) in 1985 followed by a decrease of four percent per year through 1990. (All calculations assume a constant 4.2 percent rate of inflation.) Note that even when the corporate tax rate is initially raised, effective tax rates are lower in each year of the transition period 1985-1989 than they would be were the statutory corporate tax rate lowered immediately.

6. Other Effects on the Incentive to Invest

This study has until now focused on the impact of proposed corporate tax changes on the effective corporate tax rate on an equity financed investment. Yet to the extent that new investment projects are financed by new borrowing, there will be interest deductions associated with the new project, and these would be deductible at a lower rate under BG. At the same time, individual taxes on dividends and interest payments from the corporate

Table 6

Overall Effective Tax Rates under the Bradley-Gephardt Proposal: Alternative Phase-in Plans

(percent)

Corporate Rate Pattern	1985	1986	1987	1988	1989	1990
No Phase-in	28.4	28.4	28.4	28.4	28.4	28.4
Phase-in beginning at 46 percent in 1985, ending in 1989	23.2	21.6	21.2	22.4	28.4	28.4
Phase-in beginning at 50 percent in 1985, ending in 1990	25.8	23.2	21.6	21.2	22.4	28.4

sector would decline because of the lower marginal tax rates on such income, but taxes on capital gains would increase because of the full inclusion of realized capital gains in the individual tax base. Of these four additional effects of BG on the total tax burden associated with corporate source income, two represent tax increases and two represent tax decreases. Calculations in Appendix E suggest that the net impact of the additional changes will probably be an additional increase in the overall tax burden on new corporate capital, but that this effect is quite uncertain in magnitude.

7. Conclusions

The results of this study suggest that, as currently structured, the Bradley-Gephardt proposal would substantially reduce distortions in the allocation of capital within the corporate sector by narrowing the range in effective tax rates in new corporate investment across assets and industries. At the same time, the proposal would provide substantial windfall gains to the owners of existing capital assets in the form of unanticipated tax reductions, with this revenue leakage being compensated for by an increase in marginal effective tax rates. This leakage can be reduced, and tax revenues increased, without any rise in marginal effective rates, by a planned phase-in of the proposed corporate rate reduction over a period of several years.

Appendix A: Data Sources

In order to calculate effective tax rates, according to the formula presented in Appendix B, measures of the true rates at which assets decay are required. Estimates for the thirty-four asset types used in this study were made by Hulten and Wykoff (1981). These are presented in Table A1, and used in the calculations.

A 34 × 44 matrix of capital stock weights by industry for the year 1977 is used for each year to calculate industry-wide effective tax rates from the rates of individual assets. The matrix is converted to a corporate version using estimates for each industry of the fractions of equipment and structures in the industry that are held by corporations. These capital stocks themselves were derived from investment flow data by Fraumeni and Jorgenson (1981); their method of construction is described in greater detail by King and Fullerton (1984), who also made use of the matrix in their calculations.

Appendix B: Calculating Effective Tax Rates

We utilize the well-known "user cost of capital" methodology introduced by Jorgenson (1963) to calculate the return to capital, gross of taxes and depreciation, that a corporate investor must earn in order to be able to deliver a specified real after-corporate-tax return, r. The expression for this user cost, c, is:

$$c = q(r+\delta)(1-k-uz)/(1-u) \qquad \text{(B1)}$$

where q is the relative price of capital goods, δ the economic depreciation rate, k the investment tax credit, u the corporate tax rate, and z the present value of depreciation allowances per dollar of new capital, discounted at a

Table A1

Economic Depreciation Rates

Asset Class	Depreciation Rates
1. Furniture and fixtures	0.1100
2. Fabricated metal products	0.0917
3. Engines and turbines	0.0786
4. Tractors	0.1633
5. Agricultural machinery	0.0971
6. Construction machinery	0.1722
7. Mining and oilfield machinery	0.1650
8. Metalworking machinery	0.1225
9. Special industry machinery	0.1031
10. General industrial machinery	0.1225
11. Office and computing machinery	0.2729
12. Service industry machinery	0.1650
13. Electrical equipment	0.1179
14. Trucks, buses, and trailers	0.2537
15. Autos	0.3333
16. Aircraft	0.1833
17. Ships and boats	0.0750
18. Railroad equipment	0.0660
19. Instruments	0.1473
20. Other equipment	0.1473
21. Industrial buildings	0.0361
22. Commercial buildings	0.0247
23. Religious buildings	0.0188
24. Educational buildings	0.0188
25. Hospitals	0.0233
26. Other nonfarm buildings	0.0454
27. Railroads	0.0176
28. Telephone and telegraph	0.0333
29. Electric light and power	0.0300
30. Gas	0.0300
31. Other public utilities	0.0450
32. Farm structures	0.0237
33. Mining, shafts, and wells	0.0563
34. Other nonresidential structures	0.0290

rate equal to r plus the expected inflation rate, since these allowances are not indexed for inflation. In years where there is a full or partial basis adjustment for the investment tax credit, this is accounted for by a reduction in z. I assume that the first year's tax credit and depreciation allowances are received immediately and not discounted.

The effective tax rate, τ, the equivalent rate of income tax, is defined implicitly by the expression

$$c = q\left(\frac{r}{1-\tau} + \delta\right) \qquad \text{(B2)}$$

Combining (B2) and (B1) leads to an explicit expression for τ:

$$\tau = \frac{\frac{(r+\delta)(1-k-uz)}{(1-u)} - (r+\delta)}{\frac{(r+\delta)(1-k-uz)}{(1-u)} - \delta} \qquad \text{(B3)}$$

In the calculations, I assume $r = .04$, and take δ from Table A1. The inflation rate used is based on the rate of change in the GNP deflator. Generally, these calculations assume that tax parameters will remain constant. The calculations in section 5, however, take explicit account of the phase-in pattern for u under the different transition schemes discussed.

To aggregate effective tax rates by industry, I calculate weighted averages of the numerator and denominator of expression (B3), based on the industry capital stock weights described above, and then divide.

Appendix C: Estimating Capital Stock Wastage

As shown in Auerbach (1983a), if each of the forty-four industries studied can be assumed to have a Cobb-Douglas production function in value added, Y_i:

$$Y_i = a_i \prod_j K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} \qquad \beta_i = \sum_j \alpha_{ji} \tag{C1}$$

where K_{ji} is the capital stock of type j (j=1,34) used in industry i and X_i is labor used in industry i, then the following expression describes the fraction of the overall corporate capital stock that could be disposed of if all remaining capital were allocated efficiently, without any change in the vector of industry outputs:

$$L = \frac{\sum_i Q_i \sum_j (\frac{\alpha_{ji}}{\beta_i})(\frac{\tilde{\rho}_i}{\rho_j} - 1) + \sum_i Q_i \left[1 - (\frac{\tilde{\rho}_i}{\bar{\rho}})^{(1-\beta_i)}\right]}{\sum_i Q_i \sum_j (\frac{\alpha_{ji}}{\beta_i})(\frac{\tilde{\rho}_i}{\rho_j})} \tag{C2}$$

where $\tilde{\rho}_j$ is the required return to capital of type j after depreciation but before taxes, $\tilde{\rho}_i$ is the weighted geometric mean of these values for industry i,

$$Q_i = \frac{Y_i \beta_i}{\tilde{\rho}_i} \tag{C3}$$

is a capital quantity index for industry i, and $\bar{\rho}$ is defined implicitly by the expression:

$$\sum_i \left[(\frac{\tilde{\rho}_i}{\bar{\rho}})^{-\beta_i} - 1 \right] (1-\beta_i) Y_i = 0 \tag{C4}$$

The derivation of values of the parameters α_{ji} and γ_i is described in Auerbach (1983a).

Appendix D

To estimate the relation between the value of an existing unit of capital and its replacement cost, note that at any time the value of the after-tax flows from a new unit of capital equals its purchase price. Normalizing this price to 1 yields:

$$1 = (1-u)F + k + uz \tag{D1}$$

where F is the present value of the asset's before-tax cash flows and k, u and z are as defined in Appendix B. For a unit of existing capital of age t, which will as productive as $(1-\delta)^t$ units of new capital (where δ is the geometric economic depreciation rate used above), the value is:

$$v^t = (1-u)F(1-\delta)^t + uz^t \tag{D2}$$

where z^t is the present value of remaining depreciation allowances for the asset. Since the asset's replacement cost is $(1-\delta)^t$, the ratio of its market value to replacement cost is:

$$q^t = \frac{v^t}{(1-\delta)^t} = (1-k-uz) + \frac{uz^t}{(1-\delta)^t} \tag{D3}$$

Using (D3), I estimate q^t for each vintage of each type of capital for each year from 1953 to the present, and aggregate them under the assumption that each net asset stock grew at 4 percent per year.[7] Capital from years before

1953 is assigned the 1953 tax treatment.

Appendix E: The Effects of Interest Deductibility and Individual Taxes

In the text, I assume that firms invest subject to the requirement that they earn a real, after-corporate tax yield of 4 percent. If this assumption is correct, then fluctuations in the effective corporate tax rate are synonymous with fluctuations in the required before-tax rate of return and, hence, the incentive to invest. However, there are additional tax considerations that may also affect the overall incentives to invest through their impact on the required corporate rate of return after-tax. For example, an increase in taxes at the individual level could lead to an increase in the required corporate yield, contrary to the assumption that this yield is constant.

To evaluate the importance of these additional effects, this appendix considers the relationship between the net corporate return, r, and the returns received by investors after account is taken of interest deductibility and personal taxes. For a derivation of these relationships, the reader is referred to Auerbach (1983b).

Let θ be the rate at which dividends are taxed, ϕ be the rate at which interest income is taxed, and μ be the accrual equivalent capital gains tax rate. Then the returns net of all taxes to suppliers of funds through retentions, new shares and debt are, respectively:

$$n_r = (r+\Pi)(1-\mu) - \Pi$$

$$n_n = (r+\Pi)\left[p(1-\theta) + (1-p)(1-\mu)\right] - \Pi \qquad \text{(E1)}$$

$$n_d = \frac{(r+\Pi)}{(1-\mu)}(1-\phi) - \Pi$$

where Π is the inflation rate, p is the dividend payout rate and, as before u is the corporate tax rate. Note that the dividend tax does not enter into the calculation for retentions; since funds raised in this way avoid the dividend tax, there is an offsetting impact that just cancels the future dividend taxation, as long as dividend tax rates remain constant. Let f_r, f_n and f_d represent the fraction of corporate finance coming from each of these three sources. Then the overall return to asset holders net of all taxes is:

$$\begin{aligned} n &= \left[f_r(1-\mu) + f_n\left(p(1-\theta) + (1-p)(1-\mu)\right) + f_d\left(\frac{1-\phi}{1-\mu}\right)\right](r+\Pi) - \Pi \\ &= [1-\psi](r+\Pi) - \Pi \end{aligned} \tag{E2}$$

where

$$\psi = f_r\mu + f_n\left(p\theta + (1-p)\mu\right) + f_d\left(\frac{\phi-u}{1-u}\right) \tag{E3}$$

is the effective rate at which the nominal return net of corporate tax, $r+\Pi$, is taxed before it reaches individual investors. Based on estimates presented by King and Fullerton (1984) for the 1970s, values of .6, .05 and .35 for f_r, f_n and f_d seem appropriate. Using King and Fullerton's 1980 standard ownership weights and tax rates for debt for 1980, I arrive at an aggregate tax rate on interest income for 1980 of $\phi = .22$ when $\Pi = .042$. Using their 1980 equity ownership weights and tax parameters leads to an estimated tax on dividends of .36. Scaling these rates down proportionally from the 70 percent top marginal tax rate in 1980 to be 50 percent and 30 percent rates of 1984 and (under BG) 1985, respectively, yields estimates for ϕ of .16 and .09 and for θ of .26 and .15, respectively. The accrual equivalent rate on capital gains is likely to be quite small because of deferral and step-up in basis at death (Bailey 1969). I assume that μ increases by .01 from 1984 to 1985.

Using these estimates, and an assumed dividend payout rate of $p = .5$, I find that a move to BG from the current tax system would lead to changes in the total tax rates on retentions, new issues and debt of +.01, -.05 and +.255, respectively. Given the assumed values of f_r, f_n, f_d, this leads to an overall increase in ϕ of 9.3 percentage points, almost all of which is due to the predicted decline in the tax rate gap between corporate borrower and individual (or institutional) lender.

These calculations are very sensitive to the specific parameters used, and are probably much less accurate than those presented for the corporate tax in the body of the paper. In particular, the effective capital gains rate is very difficult to estimate precisely. Perhaps more importantly, there remains a substantial level of disagreement about the appropriate modeling of the effects of dividend taxation. Many authors continue to argue that the dividend tax represents a burden on all equity financed investment, not just that financed by new share issues. This alternative viewpoint would be represented by setting the fractions f_r and f_n equal to 0 and .65, respectively, instead of their current values. The effect would be to reduce by more than one third the increase in ϕ associated with the move to BG. Thus, it appears that a consideration of all taxes on corporate source income reinforce the paper's finding that BG will raise marginal tax rates on new corporate investments, but by an uncertain degree.

Footnotes

1. For further discussion, see Auerbach (1982).

2. For example, Hulten and Robertson (1982) and Auerbach (1983a).

3. I use these categories because there is data available for each of the asset types on economic lifetime and average ADR midpoint lifetime, as well as an industry by industry breakdown of investment by category. Such figures, based on an even more disaggregated categorization, were constructed by Jorgenson and Sullivan (1981). These same categories have also been used in analyses by Fullerton and Henderson (1981), Hulten and Robertson (1982), Auerbach (1983a) and King and Fullerton (1984).

4. This estimate is derived in the following way. In 1981, the corporate capital stock had an estimated replacement cost of 2.05 trillion dollars, according to Musgrave (1982). Multiplying this by the change in the price deflator for nonresidential fixed investment from the beginning of 1981 to the end of 1983 yields an estimate of 2.18 trillion dollars for this capital stock in current dollars. Adding to this the price adjusted values of net nonresidential fixed investment for 1981-83, adjusted for the fraction held by corporations, yields a value of approximately 2.3 trillion dollars. Multiplied by .0325 and .0010 respectively, this yields estimates of capital stock wastage of 74.8 billion dollars and 2.3 billion dollars under current tax law and BG, respectively. At a before-tax rate of return of 8 percent, this implies a reduction in the annual income loss of 5.8 billion dollars.

5. This is based on the capital stock estimate given in footnote 4.

6. This possibility was discussed in Abel (1982) and Auerbach and Kotlikoff (1983).

7. This growth rate was found, in Auerbach (1983a), to approximate that of the overall capital stock from 1952 to 1981.

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Corporate Taxation in the United States

THE CORPORATION INCOME TAX has been the focus of much criticism and debate in the United States during the past decade. Many hold it responsible for the low level of business investment in the United States, and it has been criticized as a fundamentally unfair and illogical tax because it taxes corporations as independent entities, regardless of the tax brackets of individual shareholders. Much of the academic discussion in the 1970s about reform of the corporate tax centered on the integration of corporate and individual income taxes, to make the corporate tax essentially a withholding mechanism for the individual income tax.[1] More recently the emphasis has shifted toward reform by repeal, and indeed President Reagan himself has called for the abolition of the corporate tax.

Any analysis of the current economic effects of the U.S. corporate tax should begin with the recognition of what has happened over the years to corporate tax revenues. Put simply, the corporate tax has been disappearing. The marked drift in composition of federal revenues away

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[1] See Charles McLure, *Must Corporate Income Be Taxed Twice?* (Brookings Institution, 1979), and Martin Feldstein and Daniel Frisch, "Corporate Tax Integration: The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals," *National Tax Journal*, vol 30 (March 1977), pp. 37–52.

from the corporate tax is illustrated in table 1, which presents the revenues from income taxes since 1953 as a percentage of federal revenues and GNP. The year 1953 is significant, for it was in 1954 that Congress passed the first of many tax acts that have successively shortened the lifetimes over which tax deductions for depreciation could be taken and accelerated the depreciation deductions within such lifetimes. The common practice through 1953 was to use straight-line depreciation for tax purposes over the allowed "useful" lives for assets. In that year the corporation income tax accounted for 28.4 percent of federal receipts and 5.4 percent of GNP. Of total income tax receipts, it accounted for about 39 percent. Throughout the late 1950s and most of the 1960s, corporate revenues provided about one-third of total income tax revenues. A familiar rule of thumb from that era was that tax cuts should be "one-third business, two-thirds individual," perhaps reflecting this relatively stable ratio. By 1980, the year before passage of the Economic Recovery Tax Act, corporate revenues had declined to half the level that existed in 1953, relative to GNP. The experience since then and estimates for the next five years show important additional erosion in the corporate tax as a revenue source.

This steady downward trend stands in contrast to the stability of the individual income tax, which has ranged only between 42.8 percent and 49.0 percent of revenues over the same period, and between 7.4 percent and 9.9 percent of GNP. The corporate tax will provide revenue in 1983 equal to only a small fraction of the concurrent annual federal deficit. It is in light of this low level of receipts that many have called for the abolition of the corporate tax; though if the trend in table 1 continues, little action toward this goal might seem to be required. However, changes in aggregate revenues convey only limited information about the economic impact of the corporate tax. Underlying these statistics are important distortions in the ways firms behave, with respect not only to the overall level of investment but also financial policy, asset choice, and the degree of risk-taking. The decline in corporate tax collections does not necessarily indicate a corresponding reduction in such distortions.

The purpose of this paper is to provide an economic analysis of the impact of the corporate tax in the United States as it is now and has been during the postwar years. Among the findings are the following.

1. Even accounting for inflation, the corporate tax wedge faced by

Table 1. Sources of Federal Revenues, Fiscal Years 1953–88

	Individual income tax[a]		*Corporate income tax*	
Year	*Percent of federal revenues*	*Percent of GNP*[b]	*Percent of federal revenues*	*Percent of GNP*[b]
1953	45.2	8.6	28.4	5.4
1954	46.0	8.3	26.3	4.7
1955	44.1	7.4	28.0	4.5
1956	44.0	8.0	28.2	5.1
1957	45.3	8.3	25.7	4.7
1958	46.5	8.1	22.9	4.0
1959	44.7	7.8	25.1	4.4
1960	44.8	8.4	23.5	4.4
1961	45.9	8.3	21.1	3.8
1962	45.4	8.4	21.8	4.0
1963	45.1	8.3	21.2	3.9
1964	43.9	8.0	22.2	4.0
1965	42.8	7.4	22.6	3.9
1966	43.3	7.6	23.2	4.1
1967	44.1	8.1	20.8	3.8
1968	44.7	8.2	20.7	3.8
1969	47.5	9.6	19.4	3.9
1970	48.3	9.5	16.9	3.3
1971	45.7	8.2	16.6	3.0
1972	47.1	8.5	16.0	2.9
1973	44.6	8.1	17.1	3.1
1974	45.2	8.6	16.0	3.0
1975	45.0	8.2	14.7	2.7
1976	43.6	8.0	16.7	3.1
1977	45.4	8.7	16.1	3.1
1978	45.0	8.6	16.2	3.1
1979	46.3	9.2	15.8	3.1
1980	47.6	9.5	13.3	2.7
1981	47.5	9.9	11.5	2.4
1982	49.0	9.9	8.1	1.6
1983[c]	47.2	8.9	6.6	1.3
1984[c]	45.1	8.4	8.5	1.6
1985[c]	44.9	8.4	9.1	1.7
1986[c]	45.0	8.3	9.6	1.8
1987[c]	45.2	8.3	10.1	1.9
1988[c]	44.6	8.3	10.0	1.8

Sources: The 1953–57 period—*Economic Report of the President, January 1977*, table B-72; 1958–82—*Economic Report of the President, February 1983*, table B-76; 1983–88—Congressional Budget Office, baseline budget projections for fiscal years 1984–88.

a. Includes estate and gift taxes and nontax receipts, the last of which are not a significant amount.

b. For 1953–82, fiscal year revenues are divided by calendar year GNP.

c. Estimated.

fixed investment in the aggregate has declined steadily since the early 1950s. At its minimum, in 1981, the marginal corporate tax rate was less than one-third of its 1953 level.

2. Despite this reduction in the marginal tax rate on capital taken as an aggregate, the social cost of misallocation of capital within the corporate sector that resulted from differential asset taxation, measured as a fraction of the corporate capital stock, increased over the same period, reaching an estimated peak of 3.90 percent in 1973, and equaling 3.19 percent in 1981 with the passage of the Economic Recovery Tax Act.

3. The absence of tax refunds for losses incurred by corporations results in firms with different earnings histories having different incentives to invest. Fully taxable firms quite possibly possess a stronger incentive to invest than those in the apparently favorable position of having previous losses to carry forward. This prospect has been increased by recent legislation accelerating depreciation schedules.

4. The effect of inflation on the incentive to invest is highly sensitive to the proportion of debt finance and the gap between ordinary personal and corporate tax rates. Differences in assumptions about these parameters have led to greatly varying estimates of the impact of inflation, with the direction as well as the magnitude subject to dispute.

5. Tax reform proposals should distinguish between tax revenues and marginal tax rates. Given the current pattern of asset taxation, much of the present value of revenues that will come from the corporate tax can be attributed to assets already in place. Hence abolition of the corporate tax would accomplish a small reduction in the average marginal tax rate at the expense of a large, essentially lump-sum transfer to the owners of existing capital. This transfer would have been approximately $427 billion in 1981.

The paper begins with a review of the corporate tax and its provisions and the major changes that generated the pattern of revenues presented in table 1.

The Corporate Tax: 1953–81

The corporate tax is essentially a flat rate tax; it is currently 46 percent.[2] There has been little movement in the statutory corporate tax rate during the past three decades. As shown in the second column of table 2, the rate was reduced from 52 percent to 48 percent by the 1964 tax cut, raised temporarily by the 10 percent Vietnam War surcharge, and lowered again by the tax act of 1978 to its current level. Most of the "action" in the corporate tax has come from changes in the tax base.

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[2] Under current law the first $100,000 of a corporation's income is taxed at rates

The tax base for a nonfinancial corporation investing in fixed assets is derived by subtracting from gross sales the costs of inputs (including wages and materials), capital costs (through depreciation allowances), and interest payments. This base is effectively reduced when any of these components increases or when tax credits are allowed against calculated tax liabilities. Through various legislation, there have been increases in levels of depreciation allowances and credits at any given level of income. Increases in the inflation rate have brought declines in the real value of depreciation allowances and measured materials costs and increases in interest payments.

Either through shortened tax lifetimes or increased speed of write-off over such lifetimes, depreciation allowances were accelerated in 1954, 1962, 1971, and 1981. All these actions had the effect of raising the present value of depreciation allowances received per dollar invested. The investment tax credit was introduced in 1962, briefly suspended in 1966, removed in 1969, reinstated in 1971, increased in 1975, and altered by both the 1981 and 1982 tax acts.[3] Thus, there has been a general *legislative* movement toward reduced corporate taxation, since most nonresidential fixed investment is undertaken by corporations.

As has been emphasized by many authors, inflation affects taxable corporate profits in three important ways.[4] To the extent that the first-

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below the maximum rate of 46 percent. The only important class of corporation taxpayers without most income in the top bracket are companies with negative taxable income that face a tax rate of zero. This is discussed further below.

[3] For a historical review of these changes, see Alan J. Auerbach, "The New Economics of Accelerated Depreciation," *Boston College Law Review*, vol. 23 (September 1982), pp. 1327–55.

[4] See, for example, John B. Shoven and Jeremy I. Bulow, "Inflation Accounting and Nonfinancial Corporate Profits: Physical Assets," *BPEA, 3:1975*, pp. 557–98; T. Nicholaus Tideman and Donald P. Tucker, "The Tax Treatment of Business Profits Under Inflationary Conditions," in Henry J. Aaron, ed., *Inflation and the Income Tax* (Brookings Institution, 1976), pp. 33–77; Martin S. Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector," *National Tax Journal*, vol. 32 (December 1979), pp. 445–70; and Alan J. Auerbach, "Inflation and the Tax Treatment of Firm Behavior," *American Economic Review*, vol. 71 (May 1981, *Papers and Proceedings, 1980*), pp. 419–23.

Table 2. Average Corporate Tax Rates, 1953–82
Percent

Year	*Average corporate rate*[a]	*Statutory corporate rate*	*Difference*
1953	55.9	52.0	−3.9
1954	50.0	52.0	2.0
1955	48.4	52.0	3.6
1956	50.3	52.0	1.7
1957	49.4	52.0	2.6
1958	49.4	52.0	2.6
1959	47.6	52.0	4.4
1960	47.7	52.0	4.3
1961	46.9	52.0	5.1
1962	42.4	52.0	9.6
1963	42.2	52.0	9.8
1964	40.5	50.0	9.5
1965	38.6	48.0	9.4
1966	39.6	48.0	8.4
1967	39.4	48.0	8.6
1968	44.0	52.8	8.8
1969	46.4	52.8	6.4
1970	47.9	49.2	1.3
1971	45.1	48.0	2.9
1972	43.1	48.0	4.9
1973	45.2	48.0	2.8
1974	54.4	48.0	−6.4
1975	45.8	48.0	2.2
1976	46.2	48.0	1.8
1977	43.5	48.0	4.5
1978	43.2	48.0	4.8
1979	45.0	46.0	1.0
1980	46.6	46.0	−0.6
1981	42.6	46.0	3.4
1982	36.5	46.0	9.5

Sources: Average rates are from *Economic Report of the President, February 1983*, table B-82; statutory rates are from appendix A.

a. Corporate tax liability as a percentage of corporate profits with inventory valuation and capital consumption adjustments.

in, first-out (FIFO) inventory method is used, rising prices lead to an understatement of materials costs, and purely nominal "inventory profits" are taxed. Because depreciation allowances are based on historical asset cost, their real value declines with increases in the price level. Finally, nominal interest payments include an inflation premium that is essentially a return of principal to bondholders. Yet these payments are fully deductible to the corporate borrower. This last effect works against the first two, lowering corporate tax liabilities, though there may be offsetting effects at the individual level, both with respect to the taxation of interest received and nominal capital gains on stock.[5]

The combined impact of changes in the tax law and, through modifications in the inflation rate, implicit changes in the treatment of inventories and depreciation can be seen in table 2, which compares average corporate tax rates (corporate taxes as a percentage of corporate profits corrected with the capital consumption and inventory valuation adjustments) over the past thirty years with the statutory tax rates over the same period. (Since nominal interest payments are deducted from this profits measure, as well as the tax base, increases in interest payments lower both numerator and denominator of the average tax rate calculation.) The primary differences in the two tax rates for a given year come from investment tax credits and discrepancies between estimates of actual depreciation and materials costs and those actually deducted on tax returns. When the statutory rate exceeds the average rate, the effect of investment tax credits and accelerated depreciation allowances outweighs the erosion of such allowances and taxation of inventory gains caused by inflation.

The effects of both legislated and inflation-induced tax changes can be clearly seen in the table. In 1953 the average corporate tax rate exceeded the statutory rate. Since the inflation rate in that year was below 1 percent, this must be due to the use of straight-line depreciation that was less generous than the economic depreciation estimated for the national income accounts. With the 1954 legislation, average tax rates fell below 52 percent. The gap widened further with the introduction of the investment tax credit in 1962. As inflation increased in the late 1960s, the gap narrowed again, increasing with the additional tax incentives of 1971 and 1975 and decreasing in years of serious inflation such as 1974. Except for the initial drop in the early 1950s and the recent decline caused by the 1981 and 1982 legislation, there is no obvious trend in average corporate tax rates during the period.

There are two factors that reconcile these results with the declining revenues shown in table 1. First, the increase in nominal interest rates during the 1970s, combined with a relatively stable aggregate corporate debt-equity ratio, decreased measured corporate profits as a fraction of GNP.[6] Second, even with interest payments added back in, there is evidence that the total return to corporate capital declined during the 1970s.[7] Neither of these factors necessarily indicates a lessening of the impact of the corporate tax on behavior, as discussed below.

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[5] Estimates of the inflation-induced tax payments at the individual level are presented in Feldstein and Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector."

The Recent Tax Acts

The Economic Recovery Tax Act of 1981 substantially reduced the corporate tax burden by replacing the system of numerous asset depreciation classes with three "capital recovery" classes. Light equipment can be written off over three years, other equipment over five years, and business structures over fifteen years. The associated reduction in taxes was mitigated by the passage of the Tax Equity and Fiscal Responsibility Act of 1982, which repealed accelerations in the write-off pattern that were to have occurred in 1985 and 1986 and instituted a basis adjustment of 50 percent for the investment tax credit. That is, investors receiving the 10 percent investment tax credit now receive depreciation deductions on a base of 95 cents per dollar of capital purchased.[8] Another important change brought about by the 1982 act was the reduction and eventual repeal of the "safe-harbor leasing" mechanism introduced by the 1981 act to facilitate the transfer of tax deductions and credits from one company (typically not with positive taxable income) to another. This last change is discussed in greater detail below.

The estimated net impact of the 1981 and 1982 acts on corporate tax revenues is evident in tables 1 and 2. As a percent of GNP, corporate

[6] For more detail on this debt-equity ratio see Roger H. Gordon and Burton G. Malkiel, "Corporation Finance," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior* (Brookings Institution, 1981), pp. 131–96.

[7] This point is the subject of some dispute. Although Martin Feldstein and Lawrence Summers, "Is the Rate of Profit Falling?" *BPEA, 1:1977*, pp. 211–28, argue that observed declines were primarily cyclical, recent evidence presented in Barry Bosworth, "Capital Formation and Economic Policy," *BPEA, 2:1982*, pp. 273–317, makes a compelling case for a secular decline in the rate of return to capital.

[8] These changes are described in more detail in Auerbach, "The New Economics of Accelerated Depreciation."

tax collections fell by approximately 40 percent from 1980 to 1982, and the average corporate tax rate fell to a new low in 1982.

Identifying the Appropriate Marginal Tax Rate

Many authors have used average tax rates such as those in table 1 or related measures incorporating interest payments and personal taxes to determine the impact of the corporate tax on the incentive to invest.[9] For several important reasons, however, such measures may fail to capture changes in the marginal tax rate on income from new capital investment.

RETURNS TO NONCAPITAL FACTORS

Corporations receive income in excess of a competitive return to capital. The sources of such income may include but are not limited to the entrepreneurial ability of management and the exercise of market power. Because such income does not come from depreciable capital that benefits from accelerated depreciation allowances, nor does it qualify for an investment tax credit, it faces an effective tax rate equal to 46 percent. Such taxation is not directly relevant to the incentive to invest in fixed capital, but is incorporated in measured average tax rates.

RETURNS TO OLD CAPITAL

Even when the tax law is not changed over time (by legislation or inflation), assets of different vintages face different tax rates in a given year on the income they generate. This is easily illustrated by considering equipment purchased under the 1981 tax law. After five years, the equipment receives no depreciation allowances—its gross rents are fully taxed. In the year of its purchase, the equipment received not only a substantial depreciation allowance (15 percent) but also a 10 percent investment tax credit.[10] Because of the acceleration of depreciation allowances relative to actual depreciation, taxable income is lower in the early years of the asset's life and higher in the later years than a true measure of income. Assets face higher taxes on the income they generate in later years relative to earlier years. Since a capital investment generates income over many years, these tax rates must be combined in some useful way to derive the overall impact of taxation on that investment. Simple averaging of tax rates over vintages of assets in a given year does not give the correct answer: as a result of changes in the tax code, assets of older vintages are currently being depreciated under tax rules that do not apply to new investment; there is no reason for the relative quantities of capital by vintage to correspond to the relative incomes, which differ at different ages for a given vintage; and simple averaging ignores discounting. I return to this subject below to show how the appropriate calculation can be done.

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[9] See, for example, Feldstein and Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector."

[10] The 15 percent allowance corresponds to half of the first year of depreciation permitted a five-year asset under the 150 percent declining balance formula. The so-called half-year convention built into the 1981 formulas gives assets a half year of allowances during the first year, irrespective of purchase date.

ANTICIPATED CHANGES IN THE TAX CODE

It does not require strong assumptions about rational expectations to conclude that investors may anticipate future changes in the tax law. Sometimes these changes are embodied in legislation already in place. Such was the case in 1981, when increases in the generosity of depreciation schedules were to take place in 1985 and 1986.[11] Since existing assets generally cannot be converted to the new schedules, anticipated tax incentives can represent an implicit tax on current investment. This has long been recognized but is not accounted for in the computation of average annual tax rates.

ASYMMETRIES IN THE TREATMENT OF GAINS AND LOSSES

The tax code imposes essentially two corporate tax rates: 46 percent on positive taxable income and zero on negative taxable income. If a firm incurs a tax loss, it has two alternatives. If sufficient taxes were paid during the previous three tax years, the current tax loss may be "carried back" and used to offset previous taxable income, with a resulting tax refund equal to 46 percent of the current loss. To this extent, current losses do receive the same treatment as gains. If, however, the current loss exceeds the previous three years' taxable income, the excess must be "carried forward," with the hope that future income will be sufficient to absorb it. Since losses carried forward do not accrue interest, they decline in present value at the nominal interest rate. The current limitation to carrying forward is fifteen years, increased from seven years by the 1981 act.

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[11] Because such changes were repealed in 1982, fully rational investors might have anticipated this in 1981 and expected no change to occur in 1985 and 1986.

This feature of the tax code affects new investment in two ways. First, firms currently carrying losses forward face a different pattern of expected deductions, credits, and taxable income than do firms currently taxable. Second, even taxable firms face the possibility of being nontaxable, and therefore losing the value of tax deductions, at some future date.

The motivation behind this feature of the law may in part be protection against fraudulent losses produced by fictitious companies and "hobby" losses in which consumption expenditures are characterized by the taxpayer as business expenses. That the absence of tax deductibility was perceived as a problem for legitimate businesses became evident when the 1981 act included a provision making it easier for firms to transfer tax benefits to other firms through the guise of leasing. The complicated impact of the asymmetry of the taxes on losses and gains cannot be captured by aggregate average tax rates. Different firms could face enormously different marginal tax rates on the same new investment because of differences in their current or anticipated status with regard to taxable income.

RISK

Average tax rates for the corporate sector are calculated by comparing taxes to earnings, but these may have different risk characteristics. Corporate earnings are extremely volatile, while depreciation allowances are known with a fair amount of certainty, at least in nominal terms. The extent to which measured ex post tax rates accurately reflect the real burden imposed by the tax system ex ante has been the subject of much recent discussion.

In the remaining sections of this paper I explore the impact of these factors. I begin by temporarily setting aside the questions of tax losses and risk and consider what has happened over the past thirty years to the marginal tax rates for corporations on equity-financed investments in several classes of assets. The results enable one to compute not only aggregate marginal tax rates but also those faced by different industries. The differing incentives faced by these industries to invest in various assets result in a production distortion, which is estimated using the calculated tax-rate series.

In succeeding sections, I analyze how these basic results are affected by a more realistic treatment of risk and the asymmetric tax treatment of gains and losses and how, in the presence of personal taxes and the corporate financial decision, inflation affects the incentive to invest. Finally, an estimate is made of the extent to which accelerated depreciation has led to a reduction in the market value of corporate capital, relative to its replacement cost, as a result of the deferred taxes faced by older assets. This phenomenon is important not only when interpreting trends in corporate tax receipts but also in the evaluation of tax reform proposals that would alter the relative treatment of old and new assets.

Measuring Effective Tax Rates on Corporate Capital

In this section the focus is on the problem of determining marginal tax rates on prospective investments. The procedure is to use information on the actual composition of business fixed investment in the United States, estimated economic depreciation rates, and the tax law in each year, to derive the effective tax rates faced by individual investments in each year. These can then be aggregated to obtain overall effective tax rates. Because the focus is on fixed capital, the problem posed by the existence of noncapital income on corporate returns is eliminated. Because each vintage of assets is considered independently, the problem of aggregating vintage does not occur. The calculations assume that the relative price of capital goods and the tax rate are constant. The assumption that future tax changes are zero or are not anticipated has been the standard assumption in many related studies, so the calculations here are comparable to those of others.[12]

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[12] Studies that have calculated effective tax rates using this methodology include Charles Hulten and James Robertson, "Corporate Tax Policy and Economic Growth: An Analysis of the 1981 and 1982 Tax Acts" (Washington, D.C.: Urban Institute, 1982), and Mervyn King and Don Fullerton, eds., *The Taxation of Income from Capital: A Compar-*

The basic formula used in these calculations is the well-known Hall-Jorgenson user cost of capital, which gives the cost of a unit of capital services (under the assumption that the tax law will remain fixed) as:

$$c = q(r + \delta)(1 - k - uz)/(1 - u), \tag{1}$$

where

q = relative price of capital goods
r = real rate of return the firm must earn after corporate taxes
δ = exponential rate at which the capital good decays
k = investment tax credit
u = corporate tax rate and
z = present value of depreciation allowances obtained by discounting nominal depreciation allowances at $r + \pi$, the nominal rate, where π is the inflation rate.

Equation 1 implicitly assumes the use of equity finance, for if debt finance were used, r itself would depend on the tax rate u because of the deductibility of interest payments. If one introduces b, the fraction of the investment a firm finances with debt, at a nominal interest rate, i, and denotes the required nominal return to equity holders by e, it can be shown that[13]

$$r = bi(1 - u) + (1 - b)e - \pi. \tag{2}$$

At the margin, the firm earns zero profits after tax, in present value, if it invests until the marginal product of capital equals c. The effective corporate tax rate can be defined by asking what rate of tax, τ, on the corporation's true economic income would present the same incentive to invest, for a given rate r and the actual combination of u, k, and z. Under a pure income tax, depreciation allowances would equal economic depreciation, and the investment tax credit would equal zero. Since economic depreciation per dollar of investment equals $(1 - \delta)^t\delta$, t years after the asset's purchase, the present value of such allowances would

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ative Study of the U.S., U.K., Sweden and West Germany (National Bureau of Economic Research, forthcoming). The first of these studies, like this one, looks only at taxes at the corporate level, while the second also includes the effects of corporate interest deductibility and personal taxes.

[13] See Alan J. Auerbach, "Wealth Maximization and the Cost of Capital," *Quarterly Journal of Economics*, vol. 93 (August 1979), pp. 433–46.

be $\delta/(r + \delta)$, and hence τ would be defined implicitly by the expression

$$c = q\left(\frac{r}{1 - \tau} + \delta\right), \tag{3}$$

where c is defined as in equation 1. Combining 1 and 3 yields the solution for τ,

$$\tau = \frac{c/q - (r + \delta)}{c/q - \delta} = \frac{(r + \delta)(I - k - uz) - (r + \delta)(I - u)}{(r + \delta)(I - k - uz) - \delta(I - u)}. \tag{4}$$

Equation 4 is applied to historical data to determine the effective tax rates over time. The data come from various empirical sources and assumptions. For each asset, it is assumed that the depreciation practice followed was the most advantageous available to the investor in the year of investment. This rules out the use of straight-line depreciation in a year when, say, double-declining balance depreciation was available. Although there is evidence that not all businesses immediately switch to newly provided accelerated depreciation options, incorporating such behavior in the calculations is difficult without a more general model capable of explaining it.[14] The detailed assumptions, depreciation methods, and lifetimes are discussed in appendix A. The asset categories are those for nonresidential investment used in national income account calculations. The real economic depreciation rate, δ, used for each asset category comes from calculations based on patterns of price declines in asset resale markets.[15]

To calculate τ one also needs to know the real discount rate, r, and the inflation rate, π. Future values of π needed for the calculations of z are set equal in each year to those predicted from an ARIMA forecast based on lagged values of the inflation rate. Somewhat arbitrarily, *r* is set at 4 percent.

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[14] For evidence see Terence J. Wales, "Estimation of an Accelerated Depreciation Learning Function," *Journal of American Statistical Association*, vol. 61 (December 1966), pp. 995–1009; and Thomas Vasquez, "The Effects of the Asset Depreciation Range System on Depreciation Practices," Paper 1 (U.S. Treasury, Office of Tax Analysis, May 1974).

[15] These depreciation rates are presented in Dale W. Jorgenson and Martin A. Sullivan, "Inflation and Corporate Capital Recovery," in Charles R. Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital* (Washington, D.C.: Urban Institute, 1981), pp. 171–237. Most of the depreciation rates were originally calculated and presented by Charles R. Hulten and Frank C. Wykoff, "The Measurement of Economic Depreciation," in Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital*, pp. 81–125.

Shown in table 3 are the thirty-four asset categories for which effective tax rates are calculated, along with their estimated rates of economic depreciation. Table 4 shows the historical series for the effective tax rates for two representative assets, industrial equipment and structures, in addition to the total annual rates, derived by weighting according to the composition of the capital stock.

Table 4 clearly shows the effects of both legislated tax changes and inflation. During the 1976–78 period, for example, there were no changes in the tax law. However, as inflation declined and then increased, so did effective tax rates. The same effect is evident between 1979 and 1980. The general results are consistent with time-series estimates of the type done by Hulten and Robertson.[16] Even before 1981 the net effects of inflation and the tax law had been to keep tax rates during the 1970s, overall, at levels comparable to (or lower than) those in the mid-1960s. Adding the 1950s and the period from 1981 to 1982 leads to an overall picture of declining rates, a trend that is weaker than the decline in revenues in table 1 but stronger than that of the average effective tax rates in table 2, which are comparable in ignoring interest deductibility. This demonstrates the importance of looking at marginal tax rates.

The overall trend in aggregate tax rates masks a very strong shift between structures and equipment that is typified by the two assets in table 4. From 1953 through 1961 structures were relatively favored. Since then, almost all tax incentives have been aimed at equipment; the widening gap in effective tax rates was curbed somewhat in 1982, when the partial basis adjustment for the investment tax credit was introduced. This also served to remove, for the most part, the negative tax rates enjoyed by equipment in general. This possibility of negative tax rates merely reflects the fact that tax incentives can be so great as to lead investors to require a lower return before tax than after tax.

Effective tax rates by industry also have varied substantially over the years. The 1982 values for each of forty-four corporate industries are shown in table 5. The rates range from a maximum of 39.4 percent to a minimum of 6.3 percent. The importance of such interindustry distortions is discussed below.

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[16] Hulten and Robertson, "Corporate Tax Policy and Economic Growth."

Table 3. Asset Categories and Depreciation Rates
Percent

Category number	*Asset category*	*Depreciation rate*	*Percentage of 1978 corporate investment*
1.	Furniture and fixtures	11.00	2.7
2.	Fabricated metal products	9.17	1.7
3.	Engines and turbines	7.86	0.7
4.	Tractors	16.33	1.5
5.	Agricultural machinery	9.71	0.2
6.	Construction machinery	17.22	3.3
7.	Mining and oil field machinery	16.50	1.2
8.	Metalworking machinery	12.25	3.5
9.	Special industry machinery	10.31	2.9
10.	General industrial equipment	12.25	4.1
11.	Office, computing, and accounting machinery	27.29	4.7
12.	Service industry machinery	16.50	1.8
13.	Electrical machinery	11.79	10.4
14.	Trucks, buses, and trailers	25.37	11.9
15.	Automobiles	33.33	4.8
16.	Aircraft	18.33	1.7
17.	Ships and boats	7.50	0.8
18.	Railroad equipment	6.60	1.7
19.	Instruments	15.00	4.5
20.	Other equipment	15.00	1.5
21.	Industrial buildings	3.61	6.3
22.	Commercial buildings	2.47	7.3
23.	Religious buildings	1.88	0.0
24.	Educational buildings	1.88	0.0
25.	Hospital buildings	2.33	0.1
26.	Other nonfarm buildings	4.54	0.4
27.	Railroads	1.76	0.5
28.	Telephone and telegraph facilities	3.33	2.8
29.	Electric light and power	3.00	7.1
30.	Gas	3.00	1.1
31.	Other public utilities	4.50	0.3
32.	Farm	2.37	0.1
33.	Mining, exploration, shafts, and wells	5.63	6.1
34.	Other nonbuilding facilities	2.90	0.5

Source: Dale W. Jorgensen and Martin A. Sullivan, "Inflation and Corporate Capital Recovery," in Charles R. Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital* (Washington, D.C.: Urban Institute, 1981), p. 179.

Table 4. Effective Tax Rates for Equipment and Structures, 1953–82
Percent

Year	*General industrial equipment*	*Industrial structures*	*All assets*
1953	64.1	55.6	58.8
1954	61.0	52.3	55.5
1955	58.2	50.6	53.5
1956	59.3	51.3	54.3
1957	60.2	51.9	55.0
1958	60.9	52.3	55.6
1959	59.7	51.5	54.6
1960	60.4	52.0	55.1
1961	58.8	51.0	53.9
1962	40.3	49.1	43.3
1963	41.5	49.6	44.0
1964	27.4	47.1	37.2
1965	26.1	45.5	35.7
1966	27.4	45.8	36.5
1967	49.4	46.6	45.5
1968	37.0	51.5	43.5
1969	41.0	52.7	45.8
1970	53.5	52.0	49.7
1971	53.2	51.2	49.1
1972	16.4	51.2	32.9
1973	14.4	50.9	31.8
1974	18.3	51.5	33.9
1975	24.1	52.6	37.0
1976	26.4	53.1	35.1
1977	21.2	52.1	32.0
1978	23.2	52.4	33.2
1979	19.0	50.3	30.1
1980	22.0	50.8	31.9
1981	−6.8	41.7	17.7
1982	8.4	42.1	24.6

Source: Author's calculations as discussed in the text.

The Distortionary Impact of Differential Corporate Taxation

One of the impressive facts about the effective tax rates in table 4 is how much, in any given year, they vary across investments. Since the seminal work of Harberger, there has been much concern about the

Table 5. Effective Tax Rates, by Industry, 1982
Percent

Industry number	*Category*	*Tax rate*
1.	Food and kindred products	27.0
2.	Tobacco manufactures	24.3
3.	Textile mill products	22.8
4.	Apparel and other fabricated textile products	25.3
5.	Paper and allied products	18.3
6.	Printing, publishing, and allied industries	28.1
7.	Chemicals and allied products	20.1
8.	Petroleum and coal products	33.2
9.	Rubber and miscellaneous plastic products	19.8
10.	Leather and leather products	27.4
11.	Lumber and wood products, except furniture	25.3
12.	Furniture and fixtures	28.6
13.	Stone, clay, and glass products	24.6
14.	Primary metal industries	26.0
15.	Fabricated metal industries	23.3
16.	Machinery except electrical	24.6
17.	Electrical machinery, equipment, and supplies	24.7
18.	Transportation equipment, except motor vehicles and ordnance	30.4
19.	Motor vehicles, and motor vehicle equipment	21.3
20.	Professional photographic equipment and watches	27.0
21.	Miscellaneous manufacturing industries	25.8
22.	Agricultural production	16.8
23.	Agricultural services, horticultural services, forestry and fisheries	14.7
24.	Metal mining	34.3
25.	Coal mining	19.1
26.	Crude petroleum and natural gas extraction	32.2
27.	Nonmetallic mining and quarrying, except fuel	15.6
28.	Construction	13.1
29.	Railroads and railway express service	21.4
30.	Street railway, bus lines, and taxicab service	10.0
31.	Trucking service, warehousing, and storage	14.7
32.	Water transportation	6.3
33.	Air transportation	11.5
34.	Pipelines, except natural gas	22.9
35.	Services incidental to transportation	17.1
36.	Telephone, telegraph, and miscellaneous communication services	19.7
37.	Radio broadcasting and television	25.8
38.	Electric utilities	25.0
39.	Gas utilities	20.0
40.	Water supply, sanitary services, and other utilities	39.4
41.	Wholesale trade	18.7
42.	Retail trade	27.5
43.	Finance, insurance, and real estate	37.3
44.	Services	23.9

Source: Author's calculations. Tax rates for other years are available from the author upon request.

losses caused by the misallocation of capital between the corporate and noncorporate sectors, particularly housing.[17] Relatively less emphasis has been placed until recently on the massive distortions across industries, and within any given industry in the corporate sector. In part because of the complex way in which personal taxes interact with corporate taxes (discussed below), it is not clear that corporate investment faces a substantially higher overall tax rate than noncorporate investment. Thus distortions within the corporate sector may be as important as distortions between that sector and other sectors, and reform of the corporate tax should recognize this.

Little empirical work has been done on the losses due to differential taxation within the corporate sector. This is not surprising, given that it would require knowledge of elasticities of substitution among different types of capital and labor in production in each corporate industry, about which there is very little evidence. To provide some insight into this question, therefore, I examine the losses imposed by the corporate tax under what have come to be fairly standard "baseline" assumptions: that each industry has a production function that is Cobb-Douglas in each type of capital used and labor, and that capital is allocated so as to equate the real after-tax return across investments. This latter assumption makes it appropriate to regard the losses as long run. Under these assumptions it is possible to derive an analytic expression for and compute the loss; in particular, for the vector of outputs being produced by the corporate sector, one can calculate how much of the existing capital stock could be disposed of if the remaining capital were allocated optimally.

The analytic expression for this measure of the welfare cost of differential corporate taxation is derived in appendix B. It contains two components, each of which is nonnegative. The first, which expresses the distortion due to differential taxation *within* industries, is zero only when there is uniform taxation within each industry. The second, which expresses the distortion due to differential taxation *between* industries, is zero only when the weighted geometric means of the before-tax rates of return in each industry are the same. The measure derived here is related to that obtained by Gravelle, who also used the Cobb-Douglas assumption but aggregated the corporate sector into a single industry.[18]

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[17] Arnold C. Harberger, "Efficiency Effects of Taxes on Income from Capital," in Marian Krzyzaniak, ed., *Effects of the Corporation Income Tax* (Wayne State University Press, 1966), pp. 107–17.

When this technique is used to determine the asset-specific effective tax rates, it yields the series in table 6 for the fraction of the capital stock effectively wasted under the long-run allocation of capital according to the effective tax rates prevailing in a given year.

These distortions show no downward trend, despite the steady decline in corporate tax collections. On the contrary, the overall loss has exceeded 1.54 percent since 1972, whereas it was never as high before. The two components of the total distortion have generally moved together, with the "within" component accounting for about four-fifths of the distortion. Major increases in the degree of distortion occurred in 1964, with the repeal of the Long Amendment, and in 1971, with the introduction of the Asset Depreciation Range. A smaller increase was associated with the 1981 legislation, while the basis adjustment instituted in 1982 substantially lowered the estimated distortion. The 1981 distortion implies, for instance, that 3.19 percent of the 1981 net corporate capital stock of 2.05 trillion dollars was being wasted in that year.[19] At a before-tax return of 8 percent, this would mean a loss of over $5 billion in 1981. It should be emphasized that this measure does not take into account the change in *mix* of outputs within the corporate sector and the relative levels of production in the corporate and noncorporate sectors that could be expected to flow from the tax inequalities. Such changes would increase the welfare loss.

Tax Losses under the Corporate Tax

Over the years, as depreciation schedules have become more accelerated, more firms have found themselves without taxable income against

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[18] Jane G. Gravelle, "The Social Cost of Nonneutral Taxation: Estimates for Nonresidential Capital," in Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital*, pp. 239–50. Her measure also differs in the use of a Cobb-Douglas function for gross rather than net output. Although the former approach may be conceptually more appealing, only the latter allows a closed-form solution in the multi-industry case. This difference helps explain why the estimate of excess burden in this paper is somewhat higher for 1981: the elasticity of substitution is higher when the net Cobb-Douglas function is used.

[19] John C. Musgrave, "Fixed Reproducible Tangible Wealth in the United States," *Survey of Current Business*, vol. 62 (October 1982), pp. 33–38.

Table 6. The Welfare Cost of Differential Corporate Taxation, 1953–82
Percent of capital stock

Year	*Distortion within industries*	*Distortion between industries*	*Total distortion*
1953	0.59	0.13	0.72
1954	0.53	0.11	0.64
1955	0.37	0.07	0.45
1956	0.43	0.09	0.52
1957	0.48	0.10	0.58
1958	0.51	0.11	0.62
1959	0.45	0.09	0.54
1960	0.49	0.10	0.59
1961	0.40	0.08	0.48
1962	0.45	0.12	0.57
1963	0.41	0.11	0.52
1964	1.11	0.29	1.40
1965	1.01	0.26	1.27
1966	0.94	0.24	1.18
1967	0.25	0.04	0.29
1968	0.82	0.21	1.03
1969	0.62	0.16	0.78
1970	0.27	0.05	0.33
1971	0.27	0.05	0.32
1972	2.95	0.69	3.64
1973	3.17	0.74	3.90
1974	2.74	0.64	3.38
1975	2.18	0.50	2.69
1976	2.13	0.57	2.70
1977	2.69	0.71	3.40
1978	2.40	0.64	3.04
1979	2.52	0.67	3.19
1980	2.23	0.59	2.83
1981	2.64	0.55	3.19
1982	1.29	0.25	1.54

Source: Author's calculations as described in appendix B.

which to claim deductions. This is easy to understand. Under the current tax law, an investor purchasing an asset in the five-year capital recovery class receives an immediate deduction of 15 percent, a deduction of 22 percent after one year (both on a basis equal to 95 percent of purchase price), and an immediate investment tax credit. Gross receipts in the first year of at least 56.9 cents per invested dollar, that is, $(15 + 22) \times 0.95 + 10/0.46$, would be required to absorb these tax benefits, even without accounting for the fact that investment credits cannot be used to offset all taxable income. Firms without substantial existing sources of income and fast-growing firms are likely to have to carry losses back or forward. Carrying losses forward, however, essentially offsets the benefits of accelerated depreciation. This problem provided an impetus for the introduction of "safe-harbor" leasing under the 1981 tax act. To understand why this process was structured as it was and also why it was so unpopular, it helps to review why the current tax system discriminates against tax losses.

Aside from the enforcement problems mentioned above, the lack of a loss offset in the tax system possibly derives in part from a perception among policymakers that losing firms are just that: "losers." For some reasons, the stockholders of such firms are unable to replace poor management or, for some other reason, the helping hand of government is necessary to discourage such firms. The benefit of having carry-back and carry-forward provisions, so this argument continues, is that successful, risk-taking firms with an occasional "bad draw" would lose little or nothing, while those with more permanent problems would benefit less from these provisions.

Aside from the questionable economic merit in discriminating among firms by the state of their income, there are at least two additional problems with this approach. First, even if "losers" are initially discouraged from investing because of the prospect of nonrefundable losses, once these losses have occurred, the desire to use them up through carrying forward may offer an increased incentive to invest in the future in order to generate higher expected taxable income. Second, under a tax that does not have economic income as its base, there need be no systematic relation between a firm's taxable income and its underlying profitability. Indeed, under accelerated depreciation it is the firms whose capital stocks are growing fast that face the severest problem.[20]

"SAFE-HARBOR" LEASING AS A SOLUTION

For years before 1981, leasing was recognized as a method for transferring tax benefits among firms. That many airlines leased some or all of their planes from financial institutions was well known. By making payments to the lessor over the period of the lease timed to coincide better with the income from the project, the lessee could obtain a greater part of the value of the tax benefits, which would be transferred by the lessor in the form of reduced lease payments.

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[20] These issues are explored more fully in Alan J. Auerbach, "The Dynamic Effects of Tax Law Asymmetries," Working Paper 1152 (National Bureau of Economic Research, June 1983).

But leasing could only be used for certain assets, essentially those that could be used by a firm other than the lessee at the expiration of the lease: planes, but not dies used to make cars of a particular model. Moreover, there were other provisions that prohibited lessee finance or a fixed repurchase price option and required a "reasonable" profit for the lessor before tax, which made leases imperfect as a transfer mechanism.

Most of these hindrances were removed in 1981, and the result was a spate of "wash leases" under which cash changed hands only at the initiation of a lease, and the title to the asset in question never left the possession of the user. In this arrangement, the purchaser of the tax benefits (the lessor) received the investment tax credit and depreciation deductions in exchange for this initial "down payment," plus a stream of future tax liabilities. The transaction involved a paper loan by the lessee to make up the difference between the down payment and the full price of the asset. The tax obligations of the lessor reflected the fact that the paper lease payments received exceeded the paper interest payments by an amount equal to the principal repayments made to the lessee. In addition to the down payment, the lessee received a stream of future decreases in tax liability mirroring those of the lessor.[21]

Safe-harbor leasing was criticized and scheduled under the tax act of 1982 for repeal after 1983, to be replaced by yet another type of leasing that is referred to in the legislation as finance leasing. From initial inspection, finance leasing appears to be a hybrid of safe-harbor leasing and the pre-1981 leasing, often referred to as leveraged leasing.[22] Much of the criticism took the form of declamations against "welfare for corporations," reflecting in part news stories relating the success of firms like General Electric Company in using leases to offset its current income tax liability as well as those of *previous* years (through a carry-back) and Occidental Petroleum Corporation's use of leasing to enable it to use foreign tax credits that otherwise would have expired. But perhaps the more fundamental problem with leasing was that it did not appropriately discriminate among investors.

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[21] Leasing is described more fully and a sample wash lease outlined in Auerbach, "The New Economics of Accelerated Depreciation."

[22] The 1982 changes are discussed and analyzed in Alvin C. Warren, Jr., and Alan J. Auerbach, "Tax Policy and Equipment Leasing after TEFRA," *Harvard Law Review*, vol. 96 (May 1983), pp. 1579–98.

To understand this problem, it is helpful to define three extreme types of investor: the company with taxable profits now and for the forseeable future (the taxable company), the company with a substantial current tax loss being carried forward and little prospect for being taxable in the future (the tax-exempt company), and the company undertaking large initial investments that generate large current deductions and credits that cannot be used, but with the prospect of taxable income in the near future (the start-up company).[23] First, consider the case in which no deductions are generated by the use of debt finance.

Under the Accelerated Cost Recovery System, the taxable investor purchasing an asset in the five-year capital recovery class in 1981 obtained, in effect, a negative tax rate on that asset: as shown in table 4, the present value of the investment tax credit and depreciation allowances from that cost recovery system slightly exceeded those that would have been available if immediate expensing were allowed for tax purposes. For the start-up firm, however, this was not the case. By having to carry forward unused credits and deductions, the benefits of acceleration were lost. By engaging in a lease, the start-up company could receive the full benefits, through the immediate down payment and the future tax deductions, timed to occur after the company had become taxable. But tax-exempt firms could engage in leases, too, and did so. Because such firms were facing roughly the same incentives to invest as the taxable firms, the receipt of the initial down payment appeared to provide them with a substantial benefit. Given down payments under five-year leases in the neighborhood of 20 cents per dollar of investment, this was an important issue.

Once debt finance is taken into account, however, these results are altered. In particular, the tax-exempt firms face the additional disadvantage of not being able to deduct interest payments. Calculations by Warren and Auerbach suggest that, for firms using all debt finance at the margin, leasing as structured under the 1981 act would have been inadequate to reduce the user cost of capital to that of the taxable corporation.[24]

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[23] The following discussion draws on the arguments in Alvin C. Warren, Jr., and Alan J. Auerbach, "Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing," *Harvard Law Review*, vol. 95 (June 1982), pp. 1752–86.

THE IMPACT OF LOSSES ON THE INCENTIVE TO INVEST

These taxable, start-up, and tax-exempt companies are extreme cases that exist only in papers such as this. In reality, each firm has a finite probability of being taxable in a particular year in the future, given its current and past experience. The discussion in this section seeks to determine how large an effect this has on the incentive to invest. The basic approach involves observing individual firms over time and estimating the probabilities of whether a firm will be taxable in a given year based on the experience of previous years, assuming the firm optimizes subject to a particular tax system. With such estimates, one can obtain the expected present value of taxes the firm will pay in connection with a new investment project, by translating the accrued tax liability (positive or negative) that the project generates in each year into a distribution of dates over which those taxes actually will be paid. Because I limit consideration to marginal projects that are assumed not to affect the firm's probabilities of being in a particular taxable position in a given year, this is a straightforward calculation. The calculations are based on observations of the tax loss carried forward by individual firms over time, inasmuch as data on annual accrued tax liabilities are not currently available.

Under current tax law, a firm with a tax loss may obtain a refund for this loss and hence be taxed as if there were a full-loss offset at the margin if the nominal value of its previous three years' taxable income is at least as large. Such losses are said to be carried back against previous income. A firm that has insufficient potential for carrying back can only carry excess current losses forward, in the hope that its nominal value can be offset against future taxable income. Losses can now be carried forward for as many as fifteen years; before 1981 they expired after seven years.

One may think of current taxable profits in a symmetric way. If, for example, the firm has a larger loss carried forward from previous years, the profits are set against the loss carried forward; the firm pays no taxes and carries forward any remaining loss to the next year. If the firm has a potential for loss carry-back in the form of previously taxed income, it pays taxes on its current income and adds it to the potential carry-back that it has available in the following year.

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[24] Ibid.

One may summarize the firm's current tax status by a continuous variable, y_t, equal to the real value of its tax loss carry-forward at the end of year t when positive and, in absolute value, equal to the firm's potential loss carry-back when negative. Whether increments to a given year's tax liabilities are paid in year t or some later year depends on the sign of y_t. If y_t is negative, whatever additional taxes (positive or negative) the firm owes are paid in year t. If y_t is positive, the firm neither receives additional benefits nor pays incremental taxes at the margin in year t. The additional liability (perhaps negative) is added to the previous loss carry-forward and is to be paid (in fixed nominal terms) in the first subsequent year when y_t is negative. To calculate the expected present value of a particular dated tax liability one must therefore know the joint distribution of y_t and its past and future values.

The modeling of y_t is complicated because its relation to its own past values depends both on the tax law and the characteristics of the firm. One would expect substantial serial correlation in y_t because the current year's taxable income or loss is likely to be small relative to the stock of losses carried forward or gains available for a potential carry-back. However, y would tend to decay even with a zero current tax liability, for two reasons. First, since an unused carry-forward (or carry-back) is a nominal claim, its real value decays at the rate of inflation. Moreover, the expiration of carry-forwards and potential carry-backs imparts a further, vintage-related decay of y.

To the extent that a firm would normally expect positive taxable income in a given year, this will tend to lead over time to negative y_t. The evolution of y_t, starting at any initial value, depends not only on the tax law (with respect to depreciation allowances and so on) but also on the firm's overall level of profitability and the stochastic process generating its annual returns. Firms facing a loss carry-forward may alter their behavior to influence y because the accrual of losses over time without interest provides an incentive to "use them up."[25]

Because even a simple specification of the evolution of y leads to a fairly complicated procedure for the derivation of the conditional probabilities needed for these calculations, I assume that all the effects just mentioned can be summarized by the first-order process,

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[25] This is discussed in Auerbach, "The Dynamic Effects of Tax Law Asymmetries."

$$y_t = \alpha + \beta y_{t-1} + \epsilon_t, \tag{5}$$

where the tax loss carry-forward, y_t, is divided by a measure of the firm's assets to correct for potential heteroscedasticity. I use the estimated variance of ϵ_t along with the estimates of α and β to generate distributions for y_t, conditional on its past value, under the assumption of normality. Using the estimated distribution of y_t conditional on y_{t-1}, that of y_{t-1} on y_{t-2}, and so forth, I can then generate the conditional probability that y_t exceeds zero, given information on whether each of $y_{t-1}, y_{t-2}, \ldots$ exceeded zero. The distribution of actual tax payments deriving from a tax liability, T_t, dated year t then equals ${}_tp_0 \times T_t$ in year t, ${}_{t+1}p_{10} \times T_t(1 - \pi_{t+1})$ in year $t + 1$, ${}_{t+2}p_{110} \times T_t(1 - \pi_{t+1})(1 - \pi_{t+2})$ in year $t + 2$, and so on, where ${}_tp_0$ is the unconditional probability of being taxable in year t, π_t is the inflation rate in year t, and ${}_{t+i}p_{1\ldots10}$ is the probability that $y_{t+i} < 0$, conditional on $y_t, y_{t+1}, \ldots, y_{t+i-1} > 0$. With a perfect loss offset, ${}_tp_0$ would equal 1, and the remaining probabilities would equal zero. Calculation of the time it takes for the probabilities $p_0, p_{10}, \ldots$ to converge to zero provides an estimate of how long a firm with a loss takes to pay its accrued taxes.

To estimate equation 5, I used the Compustat data file derived from a panel of large American corporations. The version of Compustat used contains data from 1959 to 1978. It is unfortunate that the variable y, which is defined here to be the tax loss carry-forward when positive and the potential carry-back when negative, is observed only when it is positive. That is, Compustat contains an annual observation for each firm on the tax loss carry-forward but nothing on the potential carry-back. Construction of such a number would require information on the previous three years' taxable income, which is unavailable. Thus for many observations y_t, y_{t-1}, or both, are missing.

To obtain consistent estimates of α and β, the following technique is adopted. All observations for which y_{t-1} is observed are selected and, using a standard Tobit procedure, equation 5 is estimated. From this, one can obtain predicted values of y_t for all these observations, including those for which the actual value is not available. Adding observations on y_{t+1}, for which a predicted value of y_t can now be used as the explanatory variable, I reestimated equation 5.[26] For the first stage of the estimation 1,750 observations were available for 1959–77, with most occurring in the latter part of the sample. By the method just described, another 317 observations were added for the second stage of the estimation. The resulting equation is[27]

$$y_t = -\underset{(0.009)}{0.063} + \underset{(0.023)}{0.729}\, y_{t-1} \tag{6}$$

Standard error of estimate = 0.348,

where standard errors are in parentheses, and y_t (when positive and observed) equals the firm's tax loss carry-forward divided by a corrected measure of its net capital stock.[28] The coefficients α and β conform to prior expectations that the former should be negative and the latter between zero and 1. This combination yields a long-run value of y_t that is negative and the decay of shocks away from it. The long-run value of y_t implied by 6 is -0.232; the typical firm would have available a potential carry-back equal to 23.2 percent of its net capital stock. Given observed before-tax rates of return, this represents approximately two years of profit, a reasonable figure.

This long-run value, however, is simply the mean of a long-run distribution of y_t. It is the value to which y_t would converge in the absence of shocks of above-average losses or gains. In fact, there will be a long-run probability distribution for y_t around this value that depends on the magnitude of these shocks. By assuming that the annual random shock to y_t is normally distributed, with a standard deviation equal to the standard error of estimate in 6, one can calculate the long-run probability distribution for y_t. Using this long-run distribution, one can then calculate

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[26] The argument for doing so is that otherwise α and β will be derived only from observations for which y_{t-1} is positive. Any asymmetry in the equation connected with the sign of y_{t-1} would not be discernible. In fact, this two-stage procedure, in principle, allows estimation of individual values of α and β depending on the sign of y_{t-1}. Such an experiment proved unsuccessful, however, because the coefficients for negative values of y_{t-1} were estimated with insufficient precision.

[27] Because the two stages were estimated separately, these standard errors lack the adjustment necessary to account for the fact that some values of y_{t-1} are estimated. However, given that such observations are a small part of the sample, and that the standard errors are so small relative to the coefficients, such a correction was not made here.

[28] This capital-stock measure was calculated for the Compustat firms and is described by Clint Cummins, Bronwyn Hall, and Elizabeth Laderman in "The R&D Master File: Documentation," August 1982.

Table 7. The Persistence of Loss Carry-Forward: Estimated Long-Run Transition Probabilities[a]

Number of years	*Probability that $y_t > 0$*	*Number of years*	*Probability that $y_t > 0$*
0	0.6926	11	0.0033
1	0.1041	12	0.0025
2	0.0599	13	0.0019
3	0.0397	14	0.0014
4	0.0277	15	0.0011
5	0.0199	16	0.0008
6	0.0144	17	0.0006
7	0.0105	18	0.0005
8	0.0077	19	0.0003
9	0.0058	20	0.0010
10	0.0044		

Source: Author's calculations as described in the text. The value shown for each year is the unconditional probability that a representative firm will have a tax loss carried forward for exactly this number of successive years.

[a] The last probability equals the sum of all remaining values. It is assumed in these calculations that losses cannot occur for more than twenty successive years.

(using a numerical integration technique) the probabilities p_0, p_{10}, p_{110}, and so on, as defined above: the unconditional probability of a firm being taxable in a given year, the probability of it being taxable following a loss carry-forward, following two years of loss carry-forwards, and so forth. These probabilities are presented in table 7. Even though the *expected* long-run value of y_t is negative, over 30 percent of the long-run distribution of y_t is positive. An important feature of the distribution is that it predicts that a tax obligation accrued in a given year would be paid, on average, 1.055 years later.

With these probabilities, one can estimate the effect of the asymmetric treatment of losses on the incentive to invest. This is done by first positing a certain before-tax internal rate of return on an asset and an economic depreciation rate. With these, a time pattern of marginal products for the asset can be generated. It is assumed that these returns are certain. Then, with a hypothesized pattern of depreciation allowances and investment tax credits, one can calculate the pattern of accrued tax liabilities generated by the asset over its lifetime. These are then converted into an *expected* tax payment pattern using the probabilities in table 7 and an assumed inflation rate. The latter is necessary because tax liabilities are carried forward in nominal terms, and these liabilities decay in real terms through inflation. Finally, one can calculate the internal rate of return for the firm's expected after-tax flows. Comparing

Table 8. Effective Tax Rates for Equipment and Structures: The Importance of Deferred Payment[a]

Percent

Tax law and inflation rate	*General industrial equipment*		*Industrial structures*	
	Immediate payment $p_0 = 1$	*Actual*	*Immediate payment* $p_0 = 1$	*Actual*
1965 tax law				
No inflation	13	22	38	37
4 percent	33	37	52	47
8 percent	48	47	58	52
1972 tax law				
No inflation	8	18	40	38
4 percent	27	33	55	50
8 percent	42	43	62	55
1982 tax law				
No inflation	−13	10	27	27
4 percent	0	18	38	37
8 percent	12	25	45	42

Source: Author's calculations as described in the text.

a. Tax rates labeled $p_0 = 1$ assume that tax payment occurs when liability is accrued; those labeled actual are based on table 7, using the method described in the text.

this to the assumed before-tax return using equation 4 yields, as before, a value for τ, the effective tax rate.[29]

These rates are presented in table 8 for two representative assets, industrial structures and general industrial equipment. A before-tax real return of 6 percent is assumed, and the economic depreciation rates listed in table 3 (0.0361 and 0.1225, respectively) are used. Estimates are given of τ for the tax laws of the mid-1960s, of the early 1970s, of the present period, and for inflation rates of zero, 4, and 8 percent. Also presented are the effective tax rates, comparable to those in table 4, based on the assumption that taxes are paid when the liability is accrued.

It should be kept in mind that the estimates on which the probabilities are based come from a reduced-form equation that would not necessarily be stable over changes in tax regime or economic environment. The value of p_0, for example, will undoubtedly be lower in the 1980s because of the tax changes enacted in 1981. Thus estimates of the impact of losses for 1982 probably understate their actual importance. However, one can view the results as illustrations of the general magnitude of the effect that loss carry-forwards and carry-backs may have.

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[29] These calculations are based on a fixed before-tax return, rather than those above, which started with the after-tax return and generated a before-tax return. The difference lies only in that the overall level at which the two rates are compared will normally differ.

A second point about τ is that it implicitly assumes risk neutrality with respect to the risky tax payments. This makes sense if the risk is entirely diversifiable. Otherwise, additional corrections of the type discussed in the next section are necessary.

Table 8 contains many interesting results. First, it shows that tax rates are less sensitive to inflation once tax deferral has been taken into account. Moreover, tax deferral lowers effective tax rates for structures, but generally raises them for equipment. To understand this, it helps to consider separately the tax liabilities generated by gross rents and the benefits generated by depreciation deductions. The deferral of tax payments through losses benefits the firm, but the deferral of deductions hurts it. It is possible that either effect can dominate. The larger the depreciation allowances relative to gross income, the more likely it is that their deferral will outweigh deferral of tax payments and lead to a net increase in tax rates. In general, the lower the effective tax rate, the more likely it is that deferral will raise it. This is evident at zero inflation from a comparison of the values for the representative equipment and structure and is reinforced by the relative impact of inflation, which lowers the value of depreciation allowances an asset receives.

These calculations indicate how a typical firm will be affected by the carry-forward and carry-back provisions of the tax law in the long-run. In any year, however, each firm will have a different tax history and, in the terminology here, a different value of y_t. That firms face the same incentives in the long run should not be confused with the fact that a firm with a large loss carry-forward faces very different incentives than one with a large potential carry-back. To quantify the importance of this difference, I generated the matrices of annual loss probability distributions, one for a firm with an initial value of y_t that is one standard deviation below its long-run mean (a "high-tax" firm) and one with an initial value of y_t that is one standard deviation above its long-run mean (a "low-tax" firm). After several years the entries in each matrix converge to the steady-state probabilities shown in table 7. In the short run, however, actual history is very important.

Effective tax rates for these firms, comparable to the columns labeled actual in table 8, are shown in table 9. The striking outcome in this table is that the firms with higher recent taxable profits, which are also more likely to be taxable in the near future (the high-tax firms) face *lower*

Table 9. Effective Tax Rates: The Importance of Deferred Payment, by Taxable Status[a]
Percent

Tax law and inflation rate	*General industrial equipment*		*Industrial structures*	
	Low tax	*High tax*	*Low tax*	*High tax*
1965 tax law				
No inflation	17	12	37	37
4 percent	33	30	48	48
8 percent	47	43	53	53
1972 tax law				
No inflation	12	7	40	38
4 percent	28	23	52	52
8 percent	40	35	57	57
1982 tax law				
No inflation	−3	−15	27	25
4 percent	10	−3	37	35
8 percent	20	5	42	42

Source: Author's calculations as described in the text.
a. Tax rates labeled high tax assume an initial value of y_t that is one standard deviation below long-run mean; those labeled low tax assume an initial value of y_t that is one standard deviation above mean.

effective tax rates. This is because, in the early years when the differences among firms are greatest, accelerated depreciation allowances generate tax losses, especially for equipment. Being tax exempt in these years is a hindrance, not a help.

Thus the asymmetric treatment of gains and losses under the corporate tax may lower or raise taxes for the average firm and is, under recent and current tax law, most helpful for firms with a history of taxable profits.

The Corporate Tax and Risk-Taking

One of the fundamental reasons for the existence of public corporations is to allow risks to be efficiently diversified through the stock market. Various aspects of the corporate tax law influence risk-taking. Besides the discrimination against tax losses discussed above, the absence of indexing in the tax law means that uncertain inflation makes the value of depreciation deductions and nominal inventory profits uncertain. Uncertainties about future changes in the law themselves affect current decisions. However, much of the recent discussion has focused on the role of the corporate tax in sharing the private risks of corporations by collecting more revenue when profits are high and less when they are low. The existence of this risk-sharing has been understood since the seminal work of Domar and Musgrave and of Tobin, but the implications for the effective taxation of risky assets under general systems of taxation have not been fully developed.[30]

Suppose assets are risky both in their gross yield (before depreciation and taxes) and in the rate at which they depreciate. The current tax system does not absorb a proportion of the net yield (gross yield less depreciation) but rather a proportion of the *gross* yield less a predetermined allowance for depreciation. This has the effect of lessening the risk-sharing of the tax system because fluctuations in the net return that result from variations in the depreciation rate do not alter the assets' tax liability.

In appendix C it is shown that the effective tax rate on a risky investment, defined as before to be the rate of tax on economic income that would yield the same incentive to invest as the current tax system, is

$$\tau = \frac{(y + \bar{\delta} + \alpha_\delta)(1 - k - uz) - (y + \bar{\delta} + \alpha_\delta)(1 - u)}{(y + \bar{\delta} + \alpha_\delta)(1 - k - uz) - (\bar{\delta} + \alpha_\delta)(1 - u)}, \tag{7}$$

where the real, after-tax return, r, has been replaced by the safe return, y; z is now calculated using this rate plus the inflation rate; $\bar{\delta}$ is *expected* economic depreciation; and α_δ is the component of the risk premium required by investors because of the riskiness of economic depreciation. Increases in the riskiness of depreciation, through increases in α_δ, have the same effect on the firm's decisions as increases in the expected depreciation rate itself. Hence two assets that have the same overall risk premium in the absence of taxes, expected rate of depreciation, and depreciation allowances will normally face different effective tax rates, with the asset whose depreciation provides more of the overall asset risk being at a disadvantage. For this asset, the proportional tax on gross returns is of less value in the sharing of risks because the returns are not as risky.

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[30] See Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk-Taking," *Quarterly Journal of Economics*, vol. 58 (May 1944), pp. 388–422; and James Tobin, "Liquidity Preference as Behavior Towards Risk," *Review of Economic Studies*, vol. 25 (February 1958), pp. 65–86.

Table 10. Taxation and Risk: The Impact of Stochastic Returns on Effective Rates under the 1982 Tax Law

	Effective tax rate	
Capital risk, α_δ	*General industrial equipment (percent)*	*Industrial structures (percent)*
0.00	−21.8	45.6
0.02	−25.6	53.2
0.04	−29.7	59.0
0.06	−34.1	63.5

Source: Equation 7, with $y = 0.02$, $\pi = 0.06$, and δ taken from table 3. Comparable values to table 4, with $y = 0.04$ and $\alpha_\delta = 0$, are −0.3 percent and 39.7 percent, respectively.

Although there is much evidence on the risk-free rate of return, little is known about the stochastic processes generating the returns from individual assets. Bulow and Summers pointed out that the annual volatility of the stock market was many times as great as that in gross corporate earnings, suggesting that the riskiness of asset values is the dominant problem investors face.[31] However, such asset risk reflects variations in the discount rate applied to earnings as well as variations in the earnings themselves. Furthermore, such variations do not imply that the specific assets owned by firms are as risky. For example, an airline that owns its fleet of planes may have a very volatile share price without the depreciated value of the planes themselves varying very much. Hence it is difficult to infer from such market observations the quantitative importance of variations in depreciation of underlying assets. More empirical work is needed on this issue for conclusions to be drawn.

Nonetheless, it is useful to observe how the introduction of economic depreciation risk alters conclusions about effective tax rates; this is done for a range of reasonable parameter values in table 10. The table shows the values of τ under the 1982 law for an inflation rate of $\pi = 0.06$, an assumed after-tax, risk-free return of $y = 0.02$, and a range of values of α_δ from zero to 0.06. The effective tax rate is calculated for two representative assets, where $\bar{\delta}$ is set equal to the previously used values of δ in table 3. To make comparisons I set the after-tax return lower to account for the fact that this is now meant to be a risk-free rate, and assume that nominal depreciation allowances themselves do not vary, so that z is calculated using $y + \pi$ as the discount rate. The range of values for α_δ is meant to provide bounds for movements in τ. An asset for which $\alpha_\delta = 0.06$ has depreciation so risky that an additional *after-tax* return of 6 percent is required over the risk-free rate (in addition to the risk premium associated with the variability of gross flows).

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[31] Jeremy Bulow and Lawrence Summers, "The Taxation of Risky Assets," Working Paper 897 (National Bureau of Economic Research, June 1982).

Looking at table 10, one can see that the use of a lower after-tax return in itself has an ambiguous effect on the estimated effective tax rate, raising the effective tax rate for structures and lowering the rate for equipment. As α_δ rises, the effective tax rates diverge for the two classes of assets, with the rate rising for structures and falling for equipment. In general it can be shown that effective tax rates will increase with α_δ unless they are negative, in which case they will become even more negative. This is a general result that applies for any increase in the effective depreciation rate, $\bar{\delta} + \alpha_\delta$. Intuitively, one knows that once tax benefits are sufficiently large to provide the investor with a subsidy, this subsidy increases in size relative to the asset's present value of earnings as the lifetime of the asset declines. An increase in capital risk has the effect of shortening an asset's life because it leads the investor to discount future flows more heavily. Thus the expectation that effective tax rates increase with capital risk is valid only if one rules out negative tax rates (which would require a nominal discount rate, $y + \pi$, of at least 11 percent for equipment).

Interest Deductibility and Personal Taxation

Both interest deductibility and personal taxes have been generally ignored until now in this discussion, and the focus has been on tax issues related to the real rather than the financial side of corporate investment. For many questions, however, these features of the tax on capital income are crucial. One of the reasons why the corporation tax receipts have declined over time has been the increase in nominal interest rates. These rising rates, combined with the deductibility of interest payments and the relative stability of the aggregate corporate debt-equity ratio, led to an increase in interest deductions. Even if this is compensated by an increase in individual tax payments, there are implications for the probability that individual corporations will fail to have taxable income and for the viability of the corporate tax as an independent vehicle for raising revenues.

Although the corporate tax is obviously relevant to the choice between corporate and noncorporate investment, the identity of the entity remitting the actual tax payment is of little consequence to the overall incentive to invest in capital. It is important therefore to understand the total tax wedge between the return to corporations before tax and the return to holders of debt and equity after tax, taking account of personal as well as corporate taxes.

Discussions in this area require an understanding of how taxes influence the corporate decision between debt and equity finance. The stability of the aggregate debt-equity ratio at about 1:3 requires some explanation, given the apparent tax advantage to debt finance.[32] Since payments to stockholders in the form of dividends are not tax deductible but interest payments are, there appears to be a strong incentive to finance with debt. Reasons often given for the relatively limited use of debt involve both tax and nontax factors.[33]

Bankruptcy costs are often cited as a reason why corporations do not borrow more. A related argument is that leverage allows a firm to lower the value of its existing long-term debt through investment decisions that make the firm riskier than had been anticipated. This possibility of "cheating" on debt-holders limits the feasible extent of debt finance.

On the tax side, there is a personal tax advantage to equity and a potential corporate tax disadvantage to debt that act to offset debt's apparent tax advantage at the corporate level. For any taxable investor, long-term capital gains receive favorable tax treatment through a 60 percent exclusion and deferral of payment of the tax until the gains are actually realized. The capital gains tax may be the only relevant tax on equity income when marginal equity funds come through retentions. Then the customary approach of weighting dividends and capital gains taxes to derive some overall personal tax rate on equity income has no justification.[34]

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[32] See Gordon and Malkiel, "Corporation Finance," and Robert Taggart, "Secular Patterns in the Financing of U.S.," in Benjamin Friedman, ed., *Corporate Capital Structure in the United States* (National Bureau of Economic Research, forthcoming).

[33] For a review of these theories see Roger H. Gordon, "Interest Rates, Inflation, and Corporate Financial Policy," *BPEA, 2:1982*, pp. 461–88.

[34] This point is developed in the literature. See Mervyn A. King, "Taxation and the Cost of Capital," *Review of Economic Studies*, vol. 41 (January 1974), pp. 21–35; Alan J.

When investment is financed through retention of earnings and hence forgone dividends, stockholders postpone paying taxes on dividends and the earnings they represent. When the retentions and the additional earnings they generate are ultimately distributed, the dividends are taxed. In this respect, the dividend tax is like a consumption tax, allowing deductions for saving by the corporation and taxing withdrawals. The after-tax rate of return is unaffected by the level of tax on dividends. Hence the net effect of such taxation is zero on new investment financed by retentions. (There would, of course, be effects induced by changes in the dividend tax rate.) The positive present value of dividend tax receipts results because the capital currently inside the corporation will be taxed upon distribution and because some equity funds will come from the sale of new shares, for which there is no corresponding personal tax saving.

Even with the relatively small capital gains tax serving as the only effective individual tax on equity income, it remains difficult to argue that very many investors would have a tax preference for equity financing, given that the maximum personal tax rate on interest income is 50 percent, only 4 points higher than the statutory corporate rate at which interest payments are deducted. Moreover, evidence from bond markets suggests that individuals in tax brackets substantially below the top marginal rate can limit their tax liability by holding tax-exempt municipal debt.[35] Hence the potential individual tax gain from holding equity versus debt would appear to be substantially below the corporate tax rate.

Even if increased leverage does not lead to a serious threat of bankruptcy, however, it increases the probability that the full value of interest deductions themselves will not be received. Hence borrowing to take advantage of tax deductibility will tend to be self-limiting. A recent study using actual corporate tax returns for 1978 estimated that under the 1983 tax law the average marginal tax rate at which interest

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Auerbach, "Share Valuation and Corporate Equity Policy," *Journal of Public Economics*, vol. 11 (June 1979), pp. 291–305; and David F. Bradford, "The Incidence and Allocation Effects of a Tax on Corporate Distributions," *Journal of Public Economics*, vol. 15 (April 1981), pp. 1–22. For a detailed discussion of its implications, see Alan J. Auerbach, "Taxation, Corporate Financial Policy and the Cost of Capital," *Journal of Economic Literature*, vol. 21 (September 1983), pp. 905–40.

[35] Joseph J. Cordes and Steven M. Sheffrin, "Estimating the Tax Advantage of Corporate Debt," *Journal of Finance*, vol. 38 (March 1983), pp. 95–105.

payments would be deductible is 0.31 percent, not allowing for the possibility of carrying back these deductions or the expected value from carrying them forward.[36] However, this may overstate the calculations based on the transition probabilities in table 7. They suggest that, with a nominal discount rate of 10 percent, a typical firm will receive about 92 cents per dollar of interest deductions, in present value, equivalent to immediate deduction at a rate of over 42 percent. Thus, assuming an individual tax rate on debt of below 30 percent, there remains an advantage to debt that can only be explained by nontax factors such as those mentioned above.

An implication of this result is that firms or individual assets for which nontax borrowing costs are small are likely to face a relatively low overall effective tax rate. It has often been supposed that this is the case for structures, as compared to equipment.[37] This would be an important offset to the apparent bias against structures imposed by the corporate tax. However, while highly leveraged purchases of apartment buildings and shopping centers by doctors and other professionals may be common, there has yet to be any convincing empirical evidence suggesting this is an important effect for corporate level investment.[38] Thus there is no evidence that the results derived above concerning differential taxation of assets would be qualitatively affected by the incorporation of interest deductibility and personal taxes in the calculations.

Inflation and the Effective Tax Rate

The primary reason why effective corporate tax rates did not fall appreciably during the 1970s was that inflation increased steadily over the period. This decreased the real value of depreciation allowances received and led to the taxation of nominal inventory profits. For capital purchased by corporations, however, the overall incentive to invest is affected by inflation in three additional ways: through the increase in inflation premiums on debt that are tax deductible, through the increased individual taxation of such premiums, and through the taxation of capital gains of shareholders that are purely nominal in character. The aggregate impact of inflation on the effective tax on capital has been the subject of several studies. Two of the major studies reached quite different conclusions about the sensitivity to inflation of the tax wedge on corporate source income.

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[36] Gordon and Malkiel, "Corporation Finance," estimate that, before the tax reduction of 1981, the marginal tax rate implicit in municipal debt was between 20 percent and 30 percent.

[37] This viewpoint is stated, for example, in Robert E. Hall, "Tax Treatment of Depreciation, Capital Gains, and Interest in an Inflationary Economy," in Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital*, pp. 149–66.

[38] I found no evidence using firm panel data (which included information on asset composition) that structures were financed more heavily with debt than equipment. I did find, however, that the presence of a tax loss carry-forward exerted a negative impact on leverage, as would be expected. See Alan J. Auerbach, "Real Determinants of Corporate Leverage," in B. Friedman, ed., *Corporate Capital Structure in the United States* (National Bureau of Economic Research, forthcoming).

Feldstein and Summers estimated the total tax wedge by combining a weighted average of estimated marginal tax rates of holders of corporate securities with average tax rates at the corporate level, and found the total tax rate to be very sensitive to inflation.[39] For example, they estimated that in 1970 there was a total effective tax rate on corporate source income of 76.8 percent at an inflation rate of 5.5 percent, with 26.6 percent of the taxes collected due to inflation. This translates into an increase of 3.3 percentage points in the total effective tax rate per percentage point increase in the inflation rate.

Using a cost-of-capital methodology such as the one used in this paper to account for both corporate and individual taxes, King and Fullerton found both a lower tax wedge and a much smaller sensitivity to the inflation rate.[40] Under the same 1970 tax law, they estimated that a rise in the inflation rate from zero to $6\frac{2}{3}$ percent would have raised the estimated effective tax rate by 3.5 percentage points, from 43.7 to 47.2 percent, or 0.5 percentage point per percentage point increase in the inflation rate.

The major reason for the difference in the conclusions of these two studies appears to be differing assumptions about the marginal tax rate for individuals and the marginal tax rate faced by financial intermediaries. Estimates of the impact of inflation are particularly sensitive to assumptions about the marginal tax rate faced by recipients of corporate interest payments. An expression analogous to equation 4 can be derived for the total effective tax rate, τ_T, accounting for interest deductibility and all

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[39] Feldstein and Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector."

[40] King and Fullerton, eds., *The Taxation of Income from Capital.*

Table 11. The Sensitivity of Effective Overall Tax Rates to Interest Deductibility and Inflation[a]

Percent

Inflation rate	*General industrial equipment*				*Industrial structures*			
	Base	*Low*	*Intermediate*	*High*	*Base*	*Low*	*Intermediate*	*High*
No inflation	−47.6	−70.9	−54.0	−45.5	25.3	13.5	22.1	26.4
4 percent	−11.4	−46.5	−21.1	−7.5	36.3	16.2	30.7	38.5
8 percent	8.2	−35.3	−3.8	13.2	42.3	15.0	34.7	45.5

Source: Author's calculations as described in the text.

a. Low estimates assume $b = 0.5$ and $\theta = 0.2$; intermediate estimates, $b = 0.25$ and $\theta = 0.2$; high estimates, $b = 0.25$ and $\theta = 0.4$.

taxes paid by the holders of corporate securities. The expression is the same as equation 4 except that r in the second term is replaced by the net return to investors after all taxes, n, and this accounts for the fact that r itself depends on personal income tax rates and corporate interest deductibility.

$$(8) \qquad \tau_T = \frac{(r + \delta)(1 - k - uz) - (n + \delta)(1 - u)}{(r + \delta)(1 - k - uz) - \delta(1 - u)}.$$

If investors receive a real net return of n on both equity and debt and marginal equity finance is through retentions, it is easy to show that[41]

$$(9) \quad r = n\left[b\frac{1 - u}{1 - \theta} + (1 - b)\frac{1}{1 - \gamma}\right] + \pi\left[b\frac{\theta - u}{1 - \theta} + (1 - b)\frac{\gamma}{1 - \gamma}\right],$$

where γ is the accrual equivalent tax on capital gains and θ is the personal tax on interest income.

In addition to the effect on r, inflation also affects the present value of the depreciation allowances, z. Using 8 and 9, one can estimate the marginal impact of inflation on τ_T for different assets and tax parameters. This is done in table 11 for the two representative assets, industrial equipment and structures, under the current tax system. In all calculations I set $r = 0.04$, $\gamma = 0.05$, and $u = 0.46$, and estimated effective tax rates at different inflation rates under different assumptions about the parameters θ and b. For the sake of comparison, calculations based on the earlier assumptions that $\theta = b = \gamma =$ zero are presented in the

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[41] See Auerbach, "Inflation and the Tax Treatment of Firm Behavior."

"base" column. Since r is taken as given in the calculations, the net return to investors, n, varies with the rate of inflation.

As can be seen in table 11, the introduction of interest deductibility and personal taxes has the effect of lowering the overall effective tax rate on both equipment and structures for the low and intermediate cases. These are the cases in which the net impact of the additional tax features makes the net return n exceed r. It is in these same cases that an increase in inflation raises n, given r, as the initial effect is simply magnified by the increases in the nominal interest rate. This reduces the sensitivity of the overall tax rate to inflation. For the intermediate case in which the debt-assets ratio is set at 0.25 and the personal tax rate at 0.2, the effective tax rate on equipment rises from −54.0 percent to −3.8 percent, while that on structures rises from 22.1 percent to 34.7 percent as inflation increases from zero to 8 percent. The general result that the tax rates faced by short-lived assets are more sensitive to inflation has been documented previously.[42] Raising the assumed personal tax rate on interest income from 0.2 to 0.4, in line with Feldstein and Summers, makes both tax rates rise more rapidly. On the other hand, setting $b = 0.5$ instead of 0.25 essentially removes the effect of inflation on the tax rate for structures. Since it has been argued that observed debt-asset ratios may understate *marginal* leverage, this may be a reasonable assumption to make.[43] Hence it appears difficult to measure with great confidence the impact that inflation has on the effective tax rates facing fixed investment.

Asset Valuation and Deferred Taxes

Just as aggregate revenues from the corporate tax are often cited as evidence of the tax's overall impact, it is customary to measure the magnitude of tax incentives for investment by the associated loss in annual tax receipts. The error involved in doing so can be quite severe.

For example, suppose there was a change in the timing of depreciation allowances that accelerated their rate of receipt but compensated for this with a lower base on which the allowances were calculated so that the net impact on the present value of these depreciation allowances is nil. There would be no impact on the incentive to invest, nor would there be any obvious reason why the shortfall in government revenue caused by the earlier deduction of depreciation allowances would have an effect on saving: owners of assets receiving these "tax cuts" would have to repay them in the future, with interest. By assumption, the government has not given them a *net* increase in resources.

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[42] See Alan J. Auerbach, "Inflation and the Choice of Asset Life," *Journal of Political Economy*, vol. 87 (June 1979), pp. 621–38.

[43] See Joseph E. Stiglitz, "Taxation, Corporate Financial Policy and the Cost of Capital," *Journal of Public Economics*, vol. 2 (February 1973), pp. 1–34.

This argument might seem to carry over directly to the case of all taxes: if the government, in the long run, repays its debt, lower taxes today must be compensated for by higher ones in the future. A significant difference between taxes in general and taxes on capital assets is that future taxes on capital assets are immediately capitalized. One does not have to believe in Barro's altruistic families to conclude that a pure change in the timing of such tax payments will be neutral.[44] It is not even necessary that the owners of such assets look beyond the present. This neutrality is the result of simple arbitrage. Assets that already have received a tax benefit but now are liable for future "deferred taxes" are less attractive to the owner than comparable new assets that have yet to receive the initial benefits.

Consider, for example, a five-year-old piece of equipment under current law that has no remaining depreciation deductions or investment tax credits. For it, the value of $k + uz$, in the terminology used above, is zero. The cash flows that it generates in the future will be fully taxable. A comparable new asset is more attractive (*after* adjustment for differences in real productivity), because for it the value of $k + uz$ is not zero. Hence its value will be higher, by the ratio $1/(1 - k - uz)$.

A related reason why old assets should carry a discount is the general practice of introducing investment incentives that apply only to new assets. The motivation for this practice is that increases in investment tax credit or acceleration of depreciation allowances provides more "bang for the buck" in terms of reductions in the cost of capital per dollar of revenue lost. This is not surprising, given that such incentives do not lower the effective tax rate on existing capital goods, while broader changes such as corporate rate reductions do. The gap between the taxation of old and new assets caused by such investment incentives leads to a further discount in the value of old assets relative to new ones.[45] A corollary is that when there is inflation, old assets will be discounted because their depreciation allowances are based on a lower price index than those of new assets.[46]

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[44] Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82 (November–December 1974), pp. 1095–1117.

When older assets face higher effective tax rates than new ones, the resulting discount in their value may be considered to be caused by an implicit obligation to the government to pay taxes in excess of those due on comparable new assets. The difference in market value of the old and new assets should reflect the present value of the obligation. In particular, the owner of such an asset could offset this difference in future obligations by committing the difference in the value of the two assets to government debt and using the interest payments to cover the extra taxes due in the future. Hence the current tax system is equivalent to a tax that imposes the same effective rate on old and new assets, combined with a liability of owners of old assets to the government equal to the total tax-induced discount on old assets under the current system.

Recognizing this point is important because tax revenues in a given year can change for many reasons: a change in the corporate tax burden in general, a change in the relative tax burdens on old and new assets, or a change in the timing of the collections. These have very different substitution effects through the cost of capital and very different income effects through changes in the value of existing assets. It is impossible to draw any general conclusion from a drop in current corporate revenues about whether the incentive for corporations to invest has increased or whether potential crowding out has been increased through a rise in private wealth.

For example, an upward movement in the statutory corporate tax rate, combined with a further acceleration of depreciation allowances aimed at maintaining the same incentive to invest in new capital, would increase the present value of corporate tax receipts by what is essentially a lump-sum tax on existing capital. This may be thought of as forcing the owners of such capital to assume an additional debt to the government. The real effects of such a policy would be equivalent to that of a one-time lump-sum tax used to retire government debt, a scheme without direct substitution effects. Yet, as measured, this policy would quite possibly appear to increase the current deficit, due to the acceleration of depreciation allowances on new capital.[47] It would clearly be desirable to have annual corporate revenues after adjustment include changes in the value of the deferred tax liability of asset holders to the government. Assuming that markets capitalize future taxes, such an adjustment is equivalent to an estimate of the size of the discount on existing capital due to the tax system.

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[45] This presumes that old assets are not sold to take advantage of the new provisions. Even ignoring transaction costs, such behavior would only yield a net reduction in taxes for a small fraction of the capital stock, because of the tax treatment of the sale and the limited availability of the investment tax credit for used assets. See Auerbach, "Inflation and the Tax Treatment of Firm Behavior," and Alan J. Auerbach and Laurence Kotlikoff, "Investment versus Savings Incentives: The Size of the Bang for the Buck and the Potential for Self-Financing Business Tax Cuts," in L. H. Meyer, ed., *The Economic Consequences of Government Deficits* (Kluwer-Nijhoff, 1983), pp. 121–49.

[46] See Auerbach, "Inflation and the Choice of Asset Life."

To estimate the relation between the value of an existing unit of capital and its replacement cost, note that at any time the value of the after-tax flows from a new unit of capital equals its purchase price. Normalizing this price to 1 yields

$$1 = (1 - u)F + k + uz, \tag{10}$$

where F is the present value of the asset's before-tax flows, and u, k, and z are as defined in equation 1. For an existing capital good of age t, which under the assumption of geometric decay is equivalent in terms of productivity to $(1 - \delta)^t$ units of new capital, the value is

$$v^t = (1 - u)F(1 - \delta)^t + uz^t, \tag{11}$$

where z^t is the present value of depreciation allowances that remain for the asset. The ratio of market value to replacement cost of such an asset, its q value, is

$$q^t = \frac{v^t}{(1 - \delta)^t} = (1 - k - uz) + \frac{uz^t}{(1 - \delta)^t}. \tag{12}$$

This differs from Tobin's q by the assumption that, except for tax effects, old capital is valued at its replacement cost. This value equals 1 when $z^t = (1 - \delta)^t (k + uz)$: assets receive tax benefits proportional to their productivity or physical value. This would be true under a tax on economic income, for then $k + uz$ would equal $\delta/(r + \delta)$ and z^t would equal $[\delta/(r + \delta)](1 - \delta)^t$. Generally, however, q^t is below 1. Even without the intentional acceleration of depreciation allowances, inflation causes the present value of old allowances based on original asset purchase prices to fall well short of the value of allowances new assets receive.

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[47] An example of this problem of confusing changes in timing and changes in the tax burden came in the discussion of my proposal with Dale Jorgenson to give investors the discounted value of economic depreciation allowances in the year of an asset's purchase. See Alan J. Auerbach and Dale W. Jorgenson, "Inflation-Proof Depreciation of Assets," *Harvard Business Review*, vol. 58 (September–October 1980), pp. 113–18. Although our original proposal would not have lowered effective tax rates on capital in the aggregate, some viewed it as infeasible because of the large "deficits" it would have produced in the initial years of its application.

Using equation 12, I estimated the values for q^t for all vintages of each of the thirty-four asset classes from 1953 to 1982, ignoring tax law changes before 1953. These vintage-specific values of q were aggregated into the annual asset-specific average of q under the assumption that each net asset stock grew over the period at a growth rate of 4 percent.[48] With the use of capital stock weights described in appendix A, these were aggregated to form a single series for the overall value of average q, shown in the first column of table 12. The series is characterized by a downward trend. In the 1950s the average q values actually exceeded unity for some assets. With the investment tax credit, accelerated depreciation, and inflation, these values fell. Large reductions occurred with the tax changes of 1962, 1972, and 1981. The corporate rate reductions in the mid-1960s and late 1970s had no observable impact, since they applied uniformly to old and new capital. Note also that q increased in years when the treatment of new capital goods was made less favorable, as occurred with the removal of the investment tax credit in 1967 and again in 1970.

As suggested above, this divergence of average q from 1 is essentially a deferred tax liability of holders of existing assets. The second column of table 12 shows the adjustments to annual revenue that would be made if such debt were explicitly accounted for. The numbers equal each year's change in the value of the implicit debt,[49] less real after-tax interest payments on the stock of such debt, based on a return of 2 percent. By

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[48] This is the annual growth rate of the net corporate stock of fixed nonresidential capital from 1952 to 1981, based on numbers presented in John C. Musgrave, "Fixed Capital Stock in the United States: Revised Estimates," *Survey of Current Business*, vol. 61 (February 1981), pp. 57–68; and Musgrave, "Fixed Reproducible Tangible Wealth in the United States."

[49] The value of the implicit debt for each year equals $(1 - q)$ multiplied by the aggregate net stock of fixed corporate capital, taken from Musgrave, "Fixed Capital Stock in the United States: Revised Estimates" and "Fixed Reproducible Tangible Wealth in the United States."

Table 12. Average Values of *q* Implied by the Corporate Tax Law, 1953–82

Year	Average *q* (ratio)	Implied revenue adjustment (billions of 1972 dollars)
1953	0.921	...
1954	0.898	7.6
1955	0.908	−2.6
1956	0.924	−4.7
1957	0.935	−3.4
1958	0.940	−1.9
1959	0.940	0.1
1960	0.946	−2.1
1961	0.945	0.5
1962	0.894	21.0
1963	0.900	−2.0
1964	0.893	4.0
1965	0.898	−0.4
1966	0.899	1.9
1967	0.927	−12.9
1968	0.889	22.6
1969	0.890	1.8
1970	0.928	−21.8
1971	0.926	1.9
1972	0.867	40.1
1973	0.864	5.1
1974	0.865	1.9
1975	0.867	−1.2
1976	0.845	17.3
1977	0.834	10.2
1978	0.835	1.6
1979	0.838	0.7
1980	0.838	2.6
1981	0.781	60.8
1982	0.792	n.a.

Source: Author's calculations as described in the text.
n.a. Not available.

this measure, corporate tax revenues were really 134.6 billion (current) dollars higher than the amount reported in 1981 because of the substantial increase in the implicit debt held by owners of existing capital.

The Future of the Corporate Tax

As a fraction of GNP, the corporate tax now raises less than a third of what it did three decades ago. While effective marginal tax rates on investment have declined accordingly, the distortions of the corporate tax structure have not. The calculations in table 6 suggest a steadily worsening allocation of fixed capital within the U.S. corporate sector.

Many other problems remain, too. The use of accelerated depreciation and the investment tax credit to reduce effective tax rates have made the problem of tax losses more acute. Any resemblance between economic income and taxable income that existed thirty years ago has vanished, and many profitable companies, particularly those that are growing, cannot use all their tax benefits. Though effective tax rates are lower than they were in the 1970s, they still are sensitive to the inflation rate because of the use of nominal magnitudes in calculating the tax base. Finally, the choice between debt and equity finance remains distorted by the presence of two levels of taxation of corporate source income.

Given the low level of corporate revenues at present, abolition of the corporate tax has its appeal. Such a move would certainly alleviate some of the problems described above. At the same time, however, it would be a singularly ineffective way of stimulating investment because it would reduce average tax rates much more than marginal tax rates.

As shown in table 4, the effective corporate tax rate on new, equity-financed fixed capital is now below 25 percent. Removal of the corporate tax would bring this rate to zero but would also eliminate the substantial benefit of interest deductibility. Thus it would probably result in a very small net reduction in taxation for new investments. At the same time, repeal of the corporate tax would forgive the implicit debt owed the government in deferred taxes, currently in excess of 20 percent of the fixed corporate capital stock. Given the capital stock's 1981 replacement cost of $2.05 trillion, this amounts to a transfer of $427 billion.[50]

The continued interest in the consumption tax as an alternative to the individual income tax and, indeed, the recent moves toward such a tax through the sheltering of individual capital income also provide an argument for removing the corporate tax, for capital income would not be taxed under a consumption tax. An alternative scheme that would have the same marginal impact without the windfalls is a cash-flow tax, discussed in detail by the Meade Committee in the United Kingdom as a companion for a personal consumption tax.[51] Like a consumption tax, it would amount to a tax on the difference between initial assets plus income and final assets in each tax period, in this case at the corporate level. The most straightforward method of accomplishing this would be through the immediate expensing of gross investment (real plus financial) in conjunction with the continued taxation of gross income, before depreciation. The chief drawback of the cash-flow tax, however, is that it does not solve the problem of tax losses in the way that repeal of the corporate tax would. Otherwise, the two alternatives differ primarily in the size of the wealth transfer to owners of corporations.

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[50] See Musgrave, "Fixed Reproducible Tangible Wealth in the United States."

[51] Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (London: Allen and Unwin, 1978).

If the corporate tax is not to be repealed outright, the problem of tax losses must be addressed. Straightforward economic solutions exist: unlimited carrying forward with interest, for example, would maintain protection against fraudulent loss claims while at the same time preserving the value of tax deductions for viable enterprises. But one should take warning from the recent legislative fiasco involving safe-harbor leasing. This is an area of tax policy in which common perceptions seem particularly resistant to economic evidence.

APPENDIX A

Methodology and 1954–82 Changes in Tax Code

THIS APPENDIX presents the methodology used to calculate effective tax rates in the text.

The first step in these calculations is to estimate each asset's effective tax rate according to equation 4. As already stated, it is assumed that investors all used accelerated methods where available. Investments are assumed to take place midway through the year, with the investment credit and (before 1981) half the first full year's depreciation allowances received immediately. Marginal products and remaining depreciation allowances are assumed to come at subsequent one-year intervals.

The major changes in the tax code taken into account are as follows.

1954 Introduction of accelerated methods; all assets are assumed to use double-declining balance with a switch-over to straight-

	line methodology, instead of the straight-line previously assumed.
1962	Introduction of a 7 percent investment tax credit (with full-basis adjustment) and of shortened "guideline" lifetimes by the U.S. Department of the Treasury, instead of Bulletin F lifetimes previously assumed.
1964	Repeal of basis adjustment for investment tax credit. A cut in corporate tax rate from 52 percent to 50 percent.
1965	A cut in corporate tax rate from 50 percent to 48 percent.
1967	Suspension of investment tax credit.
1968	Introduction of 10 percent surcharge on income tax.
1969	Reinstatement of investment tax credit.
1970	Removal of investment tax credit, reduction of surcharge, reduction of structures write-off to 150 percent declining balance, with switch-over to straight-line methodology.
1971	Removal of surcharge.
1972	Shortening of asset lives through the asset depreciation range system; reintroduction of investment tax credit.
1975	Increase of investment tax credit to 10 percent.
1979	Reduction in corporate tax rate from 48 percent to 46 percent.
1981	Economic Recovery Tax Act, as described in the text.
1982	Tax Equity and Fiscal Responsibility Act, as described in text.

The years listed are the first for which the changes are included. Except for the 1982 act, any change was counted in the year enacted if it was effective before July 1 of that year. Otherwise, it was deferred to the following year. The 1982 act became effective after July 1, but is included for 1982 to allow an analysis of its effects.

Special tax rules apply to public utility structures and oil-drilling equipment. The latter category is problematic because there are various depletion and write-off provisions that are difficult to capture in the current framework. The calculations here follow the assumptions used in King and Fullerton.[52]

To convert these asset-specific rates into industry rates, the capital stock matrix also used by King and Fullerton was adopted. This 44 × 34 matrix has entries equal to the estimates for 1977 of the net stock of each type of the thirty-four assets present in each of the forty-four industries. This matrix is converted to a corporate version using estimates for each industry of the fractions of equipment and structures in the industry that are held by corporations. The capital stocks themselves were derived by Fraumeni and Jorgenson, using data on capital flows and annual levels of industry-by-industry investment.[53] Further details are provided by King and Fullerton.

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[52] King and Fullerton, eds., *The Taxation of Income from Capital.*

APPENDIX B

Measuring the Deadweight Loss from Differential Corporate Taxation

ASSUMING that value added in industry i can be represented by the Cobb-Douglas production function, one obtains

$$(13) \qquad Y_i = a_i \prod_j K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} \qquad \beta_i = \sum_j \alpha_{ji},$$

where K_{ji} is the capital stock of category j used in industry i and X_i is labor used in industry i. With no loss of generality, one can define capital stock units so that the relative price of each capital good, q_j, equals 1.

Consider first the case in which capital is allocated according to the actual costs of capital imposed by the market. By the normalization that $q_j = 1$, the cost of capital type i is

$$(14) \qquad c_j = \frac{r}{1 - \tau_j} + \delta_j = \rho_j + \delta_j,$$

where τ_j is the effective tax rate, r is the real after-tax return (assumed to be 4 percent), and δ_j is the asset's depreciation rate. One may think of corporate sector allocation as being made by a single, competitive firm seeking to maximize profits, where profit equals gross output (including depreciation) less the cost of capital, subject to the constraint that the vector of actual outputs, $\overline{Y} = (\overline{Y}_1, \ldots)$, be produced and the economy's actual stock of labor, $\overline{X}$, be used. This yields a Lagrangian expression for the actual capital stock, K^a,

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[53] See Barbara M. Fraumeni and Dale W. Jorgenson, "Capital Formation and U.S. Productivity Growth, 1948–1976," in Ali Dogramaci, ed., *Productivity Analysis: A Range of Perspectives* (Martinus Nijhoff Publishing, 1981), pp. 49–70.

$$(15) \qquad K^a = \max \sum_i \left(a_i \mathop{\pi}_j K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} + \sum_j \delta_j K_{ji} - \sum_j c_j K_{ji} \right) - \sum_i \theta_i \left(a_i \mathop{\pi}_j K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} - \overline{Y}_i \right) + \phi \left(\sum_i X_i - \overline{X} \right).$$

The first-order conditions from 15 may be combined to yield

$$(16) \qquad K^a = \sum_i \left(\frac{\phi^{(1-\beta_i)} \bar{\rho}_i^{\beta_i} \overline{Y}_i}{\nu_i} \cdot \sum_j \frac{\alpha_j}{r_j} \right),$$

where

$$(17) \qquad \sum_i \left(\frac{\phi^{-\beta_i}(1 - \beta_i) \bar{\rho}^{\beta_i} \overline{Y}_i}{\nu_i} \right) = X,$$

$$(18) \qquad \nu_i = a_i \mathop{\pi}_j \alpha_{ji}^{\alpha_{ji}} (1 - \beta_i)^{(1-\beta_i)},$$

and

$$(19) \qquad \bar{\rho}_i = \mathop{\pi}_j \rho_j^{\alpha_{ji}/\beta_i}$$

is the weighted geometric mean of the required, before-tax rates of return in industry i.

Equations 16 and 17 can be simplified. Note that, under competitive conditions, the total supply of labor, $\overline{X}$, satisfies

$$(20) \qquad \overline{X} = \frac{1}{w} \sum_i (1 - \beta_i) \overline{Y}_i$$

(where w is the competitive wage), and the technological term, ν_i, also equals

$$(21) \qquad \nu_i = \bar{\rho}_i^{\beta_i} w^{1-\beta_i}.$$

One may choose the units of labor so that $w = 1$, with no loss of generality, and use equations 20 and 21 to reexpress 16 and 17:

$$(22) \qquad K^a = \sum_i \phi^{(1-\beta_i)} \overline{Y}_i \cdot \sum_j \alpha_j / \rho_j,$$

where

$$\sum_i (\phi^{-\beta_i} - 1)(1 - \beta_i)\bar{Y}_i = 0. \tag{23}$$

The solution to 23 is $\phi = 1$. This is not surprising because ϕ is the shadow price of labor (see 15), that is, the market wage.

The minimum capital stock necessary to produce $\bar{Y}$, holding $\bar{X}$ fixed, is found by solving the Lagrangian,

$$K^* = \min \sum_i \sum_j K_{ji} - \sum_i \lambda_i (a_i \prod_i K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} - \bar{Y}_i) + \gamma\left(\sum_i X_i - \bar{X}\right). \tag{24}$$

Using the same solution technique as before, one obtains

$$K^* = \sum_i \left(\frac{\gamma^{(1-\beta_i)} \beta_i Y_i}{\nu_i}\right), \tag{25}$$

where

$$\sum_i \left(\frac{\gamma^{-\beta_i}(1 - \beta_i)\bar{Y}_i}{\nu_i}\right) = \bar{X}. \tag{26}$$

Again using 20 and 21, 25 and 26 can be rewritten as

$$K^* = \sum_i \gamma^{(1-\beta_i)} \hat{\rho}_i^{-\beta_i} \beta_i \bar{Y}_i, \tag{27}$$

where

$$\sum_i [(\gamma\hat{\rho}_i)^{-\beta_i} - 1](1 - \beta_i)\bar{Y}_i = 0. \tag{28}$$

The term γ may be thought of as the inverse of the weighted-average aggregate cost of capital. If $\hat{\rho}_i$ were constant across i, it would equal $1/\gamma$. For purposes of exposition, we define $\bar{\rho} = 1/\gamma$. Subtracting the expression for K^* from that for K^a yields an expression for the "wasted" capital stock,

$$\Delta K = \sum_i Q_i \sum_j \left(\frac{\alpha_{ji}}{\beta_i}\right)\left(\frac{\hat{\rho}_i}{\rho_j} - 1\right) + \sum_i Q_i\left[1 - \left(\frac{\hat{\rho}_i}{\bar{\rho}}\right)^{(1-\beta_i)}\right], \tag{29}$$

where

$$Q_i = \bar{Y}_i \beta_i \hat{\rho}_i^{-1}. \tag{30}$$

It may be shown that the first sum on the right-hand side of 29 achieves a minimum of zero when $\hat{\rho}_i = \rho_j \forall_{i,j}$, and that the second term achieves a minimum of zero when $\hat{\rho}_i$ is constant over i and (by 28) equal to $\bar{\rho}$. Hence it is natural to interpret these terms as the wastage due to variation in effective tax rates within industries, and between them, respectively. Dividing equation 29 by equation 22 gives an estimate of the *fraction* of the capital stock that is wasted,

$$(31) \quad L = \frac{\Delta K}{K} = \frac{\sum_i Q_i \sum_j \left(\frac{\alpha_{ji}}{\beta_i}\right)\left(\frac{\hat{\rho}_i}{\rho_j} - 1\right) + \sum_i Q_i \left[1 - \left(\frac{\hat{\rho}_i}{\bar{\rho}}\right)^{(1-\beta_i)}\right]}{\sum_i Q_i \sum_j \left(\frac{\alpha_{ji}}{\beta_i}\right)\left(\frac{\hat{\rho}_i}{\rho_j}\right)}.$$

To solve 31, I set β_i equal to the share of capital in value added in industry i taken from the 1972 Census of Manufactures, $\bar{Y}_i$ equal to that value added, and use the 1977 capital stock weights described in appendix A for (α_{ji}/β_i). Because three of the forty-four industries (numbers 38, 39, and 40) are combined in the Census (which has forty-two industry categories), I combine these three industries' capital stocks in doing the calculations. The terms ρ_j come from each year's estimated effective tax rates by asset category.

APPENDIX C

Estimating the Effective Tax Rate on Risky Assets

THE ANALYSIS in this section uses the methodology presented in Alan J. Auerbach, "Evaluating the Taxation of Risky Assets," Working Paper 806 (National Bureau of Economic Research, November 1981).

Suppose capital of a certain type is homogeneous and depreciates each year at some stochastic rate, δ, yielding a risky cash flow, f, per unit of capital. Assume for simplicity that δ and f are jointly independently and identically distributed over time with means $\bar{\delta}$ and $\bar{f}$, respectively.

Let i be the discount rate that, when applied to the mean $\bar{f}$, yields the risk-adjusted present value of $\bar{f}$. Define x similarly for δ, and let y denote the risk-free rate. Note that because depreciation represents a negative contribution to the firm's overall return, the riskiness of δ would normally lead to a risk-adjusted discount rate, x, that is *below* the risk-free rate, y. (Indeed, x may be considerably less than zero.) This corresponds to the normal result of risk reducing the value of the future expected return, in this case by magnifying δ.

A simplification is made for convenience of notation. Observe that any system of depreciation allowances and investment tax credits has the same value to the investor ex ante as a scheme that allows fractional economic depreciation at rate ψ. With this simplification, and because of the stationarity and independence of $\bar{f}$ and $\bar{\delta}$ over time, one may consider the firm as facing a series of identical one-period decisions. The condition for equilibrium is that the risk-adjusted one-period holding yield equals the interest rate, or

$$\frac{\bar{f}(1-u)}{1+i} - \frac{\bar{\delta}}{1+x} + \frac{u\psi\bar{\delta}}{1+x} = \frac{y}{1+y}, \tag{32}$$

where, as before, u is the statutory tax rate.

To solve for ψ, one must know the present value of economic depreciation. The value of this period's depreciation is $\bar{\delta}/(1 + x)$. The next period's value is the value seen from the next period per dollar of capital, also $\bar{\delta}/(1 + x)$, multiplied by the present value of capital at the beginning of next period, $[1/(1 + r)] - [\bar{\delta}/(1 + x)]$. Continuing in this way, one can obtain the present value of economic depreciation,

$$\begin{aligned} z_E = {} & \frac{\bar{\delta}}{1+x} + \left(\frac{1}{1+y} - \frac{\bar{\delta}}{1+x}\right)\frac{\bar{\delta}}{1+x} \\ & + \cdots \left[\left(\frac{1}{1+y} - \frac{\bar{\delta}}{1+x}\right)^{t} \frac{\bar{\delta}}{1+x}\right] \\ & + \cdots = \frac{\bar{\delta}}{\bar{\delta} + y\left(\dfrac{1+x}{1+y}\right)}. \end{aligned} \tag{33}$$

Thus if actual depreciation allowances provide value z, and there is an investment tax credit at rate k, one obtains

$$\psi = \frac{k + uz}{u\bar{\delta}}\left[\bar{\delta} + y\left(\frac{1+x}{1+y}\right)\right], \tag{34}$$

which, when substituted into 32, yields

$$\frac{\left[\dfrac{\bar{f}(1-u)}{1-k-uz}\right]}{1+i} - \frac{\bar{\delta}}{1+x} = \frac{y}{1+y}. \tag{35}$$

This can also be written

$$\left(\frac{\bar{f}(1-u)}{1-k-uz}-\bar{\delta}\right)=y+\alpha_f\left(\frac{1-u}{1-k-uz}\right)+\alpha_\delta, \tag{36}$$

where

$$\alpha_f=\bar{f}\left(\frac{i-y}{1+i}\right) \tag{37a}$$

$$\alpha_\delta=\bar{\delta}\left(\frac{y-x}{1+x}\right). \tag{37b}$$

The terms α_f and α_δ are the risk premiums associated with the riskiness of $\bar{f}$ and $\bar{\delta}$, respectively. At one extreme, where only f is risky, the asset's annual returns are independent. At the other extreme, with only δ risky, the asset's annual return follows a random walk with a drift of $-\bar{\delta}$.

Once again one can define the effective tax rate as the particular rate that would provide the same incentive to invest as the current system. Because under an income tax at rate τ the equilibrium condition for holding period yield is

$$\frac{\bar{f}(1-\tau)}{1+i}-\frac{\bar{\delta}(1-\tau)}{1+x}=\frac{y}{1+y}, \tag{38}$$

equations 36 and 37 can be combined to solve for the effective tax rate analogous to equation 4 in the text:

$$\begin{aligned}\tau &= \frac{(\bar{f}-\alpha_f)-(y+\bar{\delta}+\alpha_\delta)}{(\bar{f}-\alpha_\delta)-(\bar{\delta}+\alpha_\delta)} \\ &= \frac{(\bar{y}+\delta+\alpha_\delta)(1-k-uz)-(\bar{y}+\delta+\alpha_\delta)(1-u)}{(y+\bar{\delta}+\alpha_\delta)(1-k-uz)-(\bar{\delta}+\alpha_\delta)(1-u)}.\end{aligned} \tag{39}$$

The effective tax rate is precisely the rate that would apply in the absence of risk for a risk-free rate, y, and an economic depreciation rate, $\bar{\delta}+\alpha_\delta$. Hence two corrections must be made for the effective tax rates calculated above: replace the return, r, with a risk-free return and, as suggested by Bulow and Summers, consider economic depreciation to be at rate $\bar{\delta}+\alpha_\delta$.[54]

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[54] Bulow and Summers, "The Taxation of Risky Assets."

Comments and Discussion

Henry J. Aaron: Alan Auerbach has written an ambitious, original, and provocative paper on an important subject. More accurately, he has written several mini-papers on a variety of subjects and grouped them under a single title. My comments are selective.

My first comment concerns the estimates of the capital wastage from tax-related distortions.

To begin at the beginning, the corporation income tax potentially causes a variety of distortions. First, it creates a tax wedge between corporate and noncorporate activity unless other tax provisions offset it. This is the problem on which Harberger wrote his classic article.[1] This distortion is reflected in a distortion of both the composition of output and the methods of production. Although Harberger did not analyze them, additional distortions would result in the supply of factors of production. Second, the effective tax rate varies among categories of capital goods because taxable depreciation differs from true depreciation by varying amounts across classes of capital goods. The effective tax rate varies across firms both because they employ different mixes of capital goods that are variously taxed and because they have different profit histories and prospects. Although Auerbach late in his paper estimates how variations in profit histories and prospects change effective rates, he does not use these estimates in calculating capital wastage.

These features of the corporation income tax distort factor supplies and cause a misallocation of capital and labor both between the corporate and noncorporate sectors and between various industries and firms within the corporate sector. Some of both kinds of misallocation is attributable to distortions in output arising from price effects to which consumers respond; some is attributable to shifts in factor intensities as firms respond to factor prices distorted by one or another aspect of the corporation income tax. Harberger included both of these distortions in his analysis of the effects of the corporation income tax on corporate and noncorporate sectors, but his analysis was highly aggregated.

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[1] Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, vol. 70 (June 1962), pp. 215–40.

Auerbach omits some of these distortions in his analysis—those arising from shifts in factor supplies because of changes in the remuneration of labor and capital, and in output because the corporation income tax causes shifts in relative product prices. In Harberger's terms, Auerbach omits the output effects of differences in the rate of tax across classes of capital goods. Because of this treatment, some of the distortions that would show up as changes in factor supplies or in the composition of output (if factor supplies and the composition of output were not assumed frozen) show up in Auerbach's model as distortions in factor inputs. If factor supplies could change, some shifts in the intertemporal pattern of consumption and in labor supply would occur. If composition of final output could change, production would tend to shift toward those commodities relatively intensive in tax-favored types of capital, thus driving up prices of types of capital used relatively intensively in expanding sectors—and at least some of these types of capital would be those that were tax-favored. As a result, demand effects would transmute some of the factor-use distortions into factor-supply and output distortions.

The remaining distortions arise for two reasons. Even if all output were produced by one firm, the tax advantages to one class of capital relative to another would cause a firm to alter its mix of capital inputs. Removal of those price distortions would permit the firm either to produce the same output with fewer inputs or to increase output. But Auerbach treats forty-four industries, rather than two, and thirty-four types of capital, rather than one. Because the technology of production differs among firms, tax provisions favorable to certain kinds of capital will cause a reallocation of capital and of labor, and output will be reduced. Rather than calculate the loss of output, one can start with the tax-distorted situation and enquire how much less capital would suffice to produce the observed output if the distortions were removed. This is the question that Auerbach answers.

The answer depends, among other things, on the size of the tax distortions and on the substitutability of factors for one another in production. On the size of the tax-distortions, Auerbach's answer is "very large, indeed." His table 4 shows enormous differences in effective tax rates by asset class. These differences translate into a 37.66 percent lower ρ for general industrial equipment than for industrial buildings. Auerbach assumes a Cobb-Douglas production function because it is mathematically tractable, not because it is descriptively realistic.

If one treats the entire corporate sector as a single firm with two types of capital subject to this degree of distortion in the required rate of return, one can calculate either the resulting loss of output or, equivalently, the amount of capital wastage that such a rate-of-return wedge would produce. Assume a production function, $X = L^a E^b S^c$, where L is labor, E is equipment, S is structures, and X is output, standardized so that no scalar is necessary in the production function. We know that roughly 80 percent of net value added accrues to labor and that the value of the quantity of net corporate equipment approximately equals that of net corporate structures. Given these quantities, the implied production function coefficients are $a = 0.8$, $b = 0.0768$, and $c = 0.1232$. Based on this production function and the rate-of-return advantage of equipment that Auerbach reports in table 4, profit maximizing firms would equalize the money value of equipment and structures in their net capital stocks. The rate-of-return distortion would reduce output by 0.54 percent, or, equivalently, it would imply capital wastage of 2.68 percent.

My second comment concerns the assumption of unitary elasticity of substitution. It is worth noting that, as Auerbach applies it, the adoption of a Cobb-Douglas production function is not equivalent to imposing a unitary elasticity of substitution among all types of capital. Because each industry uses only a few kinds of capital and the production function for each industry is defined only over those types of capital, Auerbach's Cobb-Douglas is equivalent to assuming a unitary elasticity of substitution among included capital goods and labor and a zero elasticity of substitution between each excluded type of capital and each included type of capital and labor. A poll of those assembled here would probably elicit a modal estimate of the average elasticity of substitution of capital for labor of about 0.75. We would agree that it is likely to vary across industries. Had Auerbach been able to use this value, his estimates of capital wastage would probably have been smaller than they are. But that leaves the question of what the elasticities of substitution among types of capital really are. We would again agree that they would vary among classes of capital and among industries, but I am not sure whether our opinions would place a weighted mean value nearer to 1.0, the assumed value for included capital goods, or to zero, the assumed value for comparisons involving excluded capital goods. The latter value would produce no change in the mix of capital inputs and no "within" distortion (see his table 6). I have no idea how a graph relating "within" distortion to the elasticity of substitution among types of capital would look, except at the end points. Nor do I know what the trade-off would be between "within" and "between" distortion.

In short, I am riding for all it is worth the discussant's famous dodge, the plea for sensitivity analysis. Some effort in this direction is essential because these estimates of distortion are important, and one needs to know how much confidence to place in them. To repeat, we need to know the consequences of different average levels of the elasticity of substitution among types of capital and of dispersion around that average. Even if we cannot estimate these elasticities, at least we can have some sense of how much our ignorance matters.

My third comment relates to policy implications of the empirical section of the paper. The section on the effects of incomplete loss carrybacks and delayed tax savings from losses that are carried forward (table 8) very nicely distinguishes the importance of this adjustment under three tax laws and at three rates of inflation. But there is no indication in the text accompanying table 6 or in table 6 itself of what changes in the corporation income tax, apart from total repeal, will go farthest toward lowering distortion. I strongly suspect, for example, that the idea advanced by two Harvard professors (one of whom, I think, has since left) for first-year capital recovery might go a long way toward reducing the wastage of capital. I fear, however, that that proposal may run afoul of Auerbach's analysis showing the unfortunate consequences of incomplete loss offsets, as first-year capital recovery, at least for a while, would drastically increase losses and possibly their dispersion as well.

Whether Auerbach's estimates of capital wastage are large or small, like beauty, is in the eye of the beholder. They certainly seem insufficient to explain the handwringing by both liberal and conservative economists over the distorting character of present rules for taxing capital income. The answer, I think, is that Auerbach in this article drops only one shoe.

The other is the personal income tax whose provisions for taxing capital income, together with institutional rigidities, cause additional distortions in the allocation of capital.

Robert E. Hall: Alan Auerbach has presented an interesting and imaginative account of a number of aspects of business taxation, covering some old ground and quite a bit of new ground. I would quibble a little with his title. The paper is really about the taxation of the earnings of corporate plant and equipment. There isn't anything about the interesting topic of taxation of other types of corporate earnings, and there is quite a bit about the taxation of plant and equipment earnings under the personal as well as the corporate income tax.

The paper shows very effectively what a monster the tax system has become, especially in the area of plant and equipment earnings. The system taxes the earnings of structures to subsidize equipment. Under the assumption Auerbach favors, the rate of subsidy on equipment is about 20 percent; the rate of tax on structures, about 30 percent (table 11). The full monstrosity of the system is not yet evident because the tax rate on existing capital is well above the rate on new capital. As time passes, the replacement of capital will erode the tax base. In later years, existing tax rates on structures will not be enough to pay the subsidy on equipment and generate current levels of revenue. All revenue estimates agree that the net revenue from the corporate tax will dwindle in the coming years.

The taxation of plant and equipment is like the old crude oil equalization tax. Under that tax, domestic production was taxed to subsidize imports. Now structures are taxed to subsidize equipment.

The deadweight burden of the unequal taxation of equipment and structures is not small. Auerbach calculates that the same output could have been produced with 2 or 3 percent less capital if the distortion favoring equipment were eliminated from the tax system. The forgone GNP is close to $10 billion a year.

The paper also puts a lot of effort into understanding the taxation of corporate income under the personal income tax. There are some very tricky issues in this area. At first, it would appear that the taxation of interest and dividends at rates of close to 50 percent under the personal tax would add quite a bit to the total effective tax rate on corporate income. However, Auerbach argues, as he has in other papers, that the taxation of dividends under the personal income tax makes no difference for effective rates on corporate income. When investment is financed by forgoing dividends now, the reduced current tax on dividends exactly makes up for the future tax on dividends financed by the return from the investment. The only personal taxes that matter are the accrual equivalent of the capital gains tax and the tax on interest income. On the margin, Auerbach argues, investment is financed mostly by equity through retained earnings, in which case the personal tax is just the capital gains rate of about 5 percent. Only about one-quarter of finance is through debt, and in that case the personal tax on the interest paid is between 20 and 40 percent.

This view brings up the murky issue of why firms pay dividends. The same firm contemplating cutting dividends to finance investment might just as well think about cutting dividends to retire debt or buy its own shares. Both unambiguously raise the value of the firm. The firm that was free to cut its dividend would easily find a reason to cut the dividend to zero.

A view with very different implications is that firms are precommitted to a certain growth path of dividends. Firms then decide between putting retained earnings into plant and equipment or into bonds. On the margin, all investment is financed by lower holdings of bonds or by issuing bonds.

Table 11 shows how sensitive Auerbach's findings are to assumptions about debt financing versus equity financing and about the tax rate on interest. If inflation is 4 percent, the subsidy rate on equipment is 46 percent if half of investment is debt financed and the rate of personal taxation of interest is 20 percent. On the other hand, if only a quarter of investment is debt financed and the tax rate on interest is 40 percent, the rate of subsidy is only about 7 percent. The tax rates on structures are 16 and 38 percent in the two cases.

My guess is that the effective fraction of debt finance is even above 50 percent because firms think of dividends as largely precommitted. I would also guess that effective taxation of interest income is not much above 20 percent. Opportunities abound for channeling interest to recipients in low tax brackets. Further, large amounts of interest income are simply unreported. The recent uproar over a modest withholding tax on interest suggests that many people think it is their moral right to escape taxation on interest.

Under my assumptions about the personal tax, equipment is heavily subsidized and structures are lightly taxed, but the qualitative conclusions of Auerbach's paper are not really changed—there is a major distortion because the tax system favors equipment over structures.

In today's tax system the federal government is pouring billions of dollars into subsidies of business equipment. Like all business subsidies, this one needs to be eliminated forthwith. Policymakers have been led to these heavy subsidies by a combination of trying to tax income and by having separate corporate and personal taxes. The fact that both taxes generate positive revenue conceals their pernicious subsidy of business equipment.

The most promising way to eliminate the gross inefficiencies of business taxation is to junk the current tax system and start again. A progressive consumption tax, administered as a value-added tax, seems the best avenue. It would guarantee effective tax rates of exactly zero on all types of investment, in place of subsidies and taxes as at present. All the efficiency and equity objectives of taxation can be achieved in a straightforward, administratively simple, and practical tax system. In that system, businesses and workers together would pay a tax based on the sales of consumption goods. Workers would receive the benefit of a graduated personal exemption, which could give the system any desired degree of progressivity.

General Discussion

Joseph Pechman questioned whether the differential tax rate on equipment and structures is the major factor responsible for the observed change in the allocation of capital. He noted significant tax differentials opened up only after 1972 whereas the ratio of investment in equipment to structures began a secular upward movement long before that. Pechman was not convinced that the tax system could fully account for this secular trend. Furthermore he was not aware of other evidence that there has been overinvestment in equipment.

Charles Schultze agreed with Pechman, arguing that the misallocative effects of the tax subsidies may be less for capital stocks than for other economic activities. If demand for investment goods is relatively inelastic to change in user costs, as suggested by the accelerator investment model, then the main effect of the subsidies is to increase firms' profits rather than the capital stock.

Jeffrey Shafer cautioned that there may be more equipment around than meets the eye: investment that is intrinsically related to structures may be fairly easily disembodied for tax purposes. While installation of central air conditioning is considered an expenditure on structures for tax purposes, installation of individual air conditioners that can be disconnected is considered equipment expenditure. A durable surface floor is an investment in structures, whereas carpets on the floor are an investment in equipment. William Brainard observed that there is considerable latitude in the classification of expenditures and that some of the reported changes may simply reflect more aggressive accounting practices by firms in response to tax incentives.

Several discussants argued that the discussion of the "misallocation" of the capital stock should recognize that social objectives other than technical efficiency are involved. George Perry suggested that the differential tax treatment reflected a desire to maximize investment stimulus per dollar of revenue lost. Congress, with the objective of increasing the capital stock and productivity, assumed that equipment was more responsive to tax subsidies than structures. Michael Lovell recalled Robert Crandall's argument that many members of Congress may favor equipment investment over structures investment because they want to encourage employment in the older industrial centers in the Northeast and Midwest by subsidizing plant modernization while avoiding the subsidization of plant movement to the Sun Belt.

John Shoven commented that the focus on the misallocation of capital within the corporate sector drew attention away from other distortions caused by the corporate income tax. Compared with the misallocations Auerbach focused on, Shoven's own work indicated that greater welfare losses from corporate income taxation came from the intertemporal misallocation of resources and from the misallocation of resources between the corporate and noncorporate sectors.

IMPACT OF TAX SIMPLIFICATION ON THE MANUFACTURING SECTOR

THURSDAY, MARCH 28, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met at 10 a.m. in room 2128 of the Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Cooper, Kaptur, Levin, Carper, Dreier, McCandless, Grotberg, and McMillan.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order. This is the second in a series of hearings our Subcommittee on Economic Stabilization is holding on the sectoral consequences of the Treasury Department's tax simplification proposal.

Today's hearing will focus on the impact of the Treasury plan on the manufacturing sector of our economy. Soon after the Treasury plan was made public in December, spokesmen for a variety of manufacturing industries, including auto, steel, and textiles, expressed concern that the plan's corporate tax provisions would have an adverse impact on their industries.

Specifically, they argued that the plan's proposals to replace our current system of accelerated depreciation with a system tied to real economic depreciation, to eliminate the investment tax credit, and to end preferential treatment of capital gains would severely penalize capital-intensive manufacturing industries which have come to depend on these tax subsidies.

These spokesmen bolstered their arguments by citing studies conducted by respected economic consulting firms such as Data Resources, Inc. and Wharton Econometrics, which they said found that the Treasury plan would increase the cost of capital, lower investment, and lead to overall reduced levels of productivity in economic growth, and a less internationally competitive American economy.

In recent weeks, however, the tide of the debate seems to be shifting. In testimony before this subcommittee 2 weeks ago, a senior economist for Wharton Econometrics stated that he now believes that the Treasury plan would not lead to lower levels of capital investment productivity and growth for the U.S. economy, and that he personally would support the Treasury plan.

In addition, studies recently conducted by, among others, the American Enterprise Institute, the Urban Institute, and the Congressional Research Service, seem to agree with the revised view of the Treasury plan expressed by Wharton Econometrics.

These studies found that the Treasury plan's proposals to lower the overall statutory corporate tax rate from 46 to 33 percent, index depreciation, interest, and capital gains to offset the effects of inflation, and permit companies to deduct half the value of the dividends paid out to shareholders would largely offset the losses due to the elimination of the capital subsidies.

These studies concluded that the Treasury tax plan would tend to equalize effective corporate tax rates among industries, but would not severely penalize any one sector. The manufacturing sector as a whole, these studies found, would not pay a significantly higher effective corporate tax rate under the Treasury plan.

In addition, these studies found that the Treasury plan as a whole would not depress levels of capital investment, but might lead to a more efficient allocation of capital that would increase productivity, economic growth, and the international competitiveness of our economy.

We are fortunate to have with us today several respected economists and a spokesman for manufacturing industries who perhaps can shed some light for us on the reasons for the differing views of the impact of the Treasury plan.

Here to testify this morning are Roger Brinner, chief economist, Data Resources, Inc.; Paul Huard, vice president for taxation and fiscal policy of the National Association of Manufacturers; Charles Hulten, senior economist of the Urban Institute; and Jane Gravelle, economist for the Congressional Research Service.

With that, we will begin our hearings. I advise all members of the panel that we have the text of your remarks and will include the entire text of your remarks in the body of the record. You are free to read your remarks or, because we will put the entire text in the record, you are free to summarize your remarks if that is your preference. In any event, I hope you will be able to read them or summarize them in no more than 10 minutes.

Having said that, let us begin first with Dr. Brinner, chief economist for Data Resources, Inc.

STATEMENT OF DR. ROGER E. BRINNER, GROUP VICE PRESIDENT AND CHIEF U.S. ECONOMIST, DATA RESOURCES, INC.

Mr. **Brinner**. Good morning. Thank you for the opportunity to appear here and I hope that the information I provide will give you some insights and perspective into the impact of the Treasury tax reform plan and, indeed, alternative tax reform plans on the American economy and on manufacturing.

The primary goal of the Treasury's new tax regime is to reduce the role of taxation, private economic decisions. The proposed code changes support this objective, given two constraints imposed by President Reagan.

First, the changes must be revenue neutral in the aggregate and, second, they must preserve the deductibility of mortgage interest payments tied to the taxpayer's primary residence.

The plan represents a major change in——

Chairman LAFALCE. Politically, you know, I suppose we will all go along with the deductibility of residential mortgages, but I hope we can get off this kick of revenue neutrality. If we are ever going to do something about the overvalued dollar and the budget deficit, we are going to have to attack both raising revenues through spending cuts and through changes in the Tax Code—not increases in taxation but changes in the Tax Code.

Mr. BRINNER. One of the issues that's come up——

Chairman LAFALCE. The sooner the President understands there's a difference between a tax increase and an increase in revenues by reform of the Tax Code, the better off the country is going to be.

Mr. BRINNER. I certainly have supported in numerous instances closing the deficit through both expense reduction and specified tax increases. If the tax reform plan gave Congress greater freedom to close the deficit by building on a base that was widely perceived to be equitable and easily understood, then the tax reform plan would have a benefit that isn't actually considered in the remarks I make.

These estimates do assume revenue neutrality.

Chairman LAFALCE. Good.

Mr. BRINNER. For largely unknown reasons, the Treasury has used the tax reform effort to shift a larger share of total Federal tax burden from personal to corporate taxpayers. According to our calculations, personal tax receipts would decline approximately 7 percent, and corporate receipts would rise slightly more than 30 percent.

While the plan would cut the top marginal rates by about one-third in both cases, the average rate for the business sector would rise significantly. What would this twist to a more neutral tax system with a heavier corporate burden do to or for the economy?

Our conclusions are the following:

First, more people would be encouraged to join the labor force and to work longer hours. About 80 percent of this gain would be married women in households with total income less than $30,000 a year.

The Nation's potential market output would benefit from this larger labor supply from the home to industry, although there certainly is value to the work being performed at home, which is missed by the national income accounts.

As a result of this greater labor supply, wage costs to manufacturing would be about 1 to 2 percent lower under the Treasury plan.

Second, the personal tax cut and expanded pay out of dividends would boost consumer expenditures. More generous shelters for retirement savings could help raise the personal savings rate, but the net effect would be higher consumption spending.

Third, heavier post-tax mortgage payments due to lower marginal tax rates and heavier taxation of secondary residences would have a negative impact on homebuilding activity and housing prices.

Fourth, businesses would curtail capital spending due to higher after-tax bond costs, weaker share prices, repeal of the investment tax credit for equipment and utility structures, less generous near-term depreciation allowances and greater investor pressure for dividend payout.

Output per hour would tend to be reduced by approximately 1 percent because of weaker total capital formation and a lower ratio of capital to labor; a gain from a more efficient allocation of our Nation's capital stock would offset much of this, but there still would be a net loss.

Total real national output in spending would be slightly lower in the first 4 years after passage of the Tax Reform Act, but then be slightly higher. And this applies to the manufacturing sector as well.

The adverse effects on housing and investment would induce a gradual drop in interest rates along with the changes in the tax treatment of interest. Within 5 years, both long- and short-term rates would be approximately 2 percentage points lower than the baseline projection. The heavier corporate tax burden would nevertheless mean a 5 to 8 percent decline, we estimate, in the stock market.

And an unintended but welcome byproduct of the proposal, the Federal deficit would be cut by lower interest rates, an effect which compounds substantially over time. Even though the plan is revenue neutral, the tax proposal would lower the deficit by approximately $70 billion per year by the first half of the 1990's.

Now of particular importance to this hearing, I believe, is the impact of the tax reform on fixed nonresidential investment. The Treasury plan proposes a reduction of the statutory corporate rate from 46 to 33 percent, elimination of the investment tax credit, and a lengthening of depreciation lifetimes. In so doing, the plan substitutes low-powered investment incentives, corporate rate cuts for high-powered investment incentives, accelerated depreciation and investment tax credits. And it raises total corporate taxes.

If we look at my exhibits on page 12, where I have tried to estimate the "bang for the buck" of these different investment incentives, you can get a quantitative impression of what I mean.

We believe that for every dollar of tax relief granted through an investment tax credit, there is an investment kick of approximately 55 cents on average over a decade.

A lower corporate rate, because it applies not only to new investment but also to old investment, has a much lower bang for the approximately 32 cents.

Other proposals to provide incentives to investment are also illustrated in the table; although not illustrated, changes in depreciation have an effect that is similar to but slightly less than the investment tax credit.

On pages 13 to 17, I provide a good deal of technical detail in the Treasury's proposed changes for depreciation. I believe the table on page 16 provides a useful summary.

If we focus on the second to the last column, and in that column, the last line of each three-line section, we can compare the present value of depreciation allowances under the Treasury system to the current system, assuming——

Chairman LaFalce. Where are you?

Mr. BRINNER. Page 16. And I am looking at the second to last column in the section labeled "Treasury as a Fraction of Current System."

Chairman LAFALCE. All right.

Mr. BRINNER. And then the 5-percent inflation column, believing that to be indicative of our medium term prospects.

If you look at the third line for each of these different asset types of equipment and structures, you see that the Treasury proposal would allow depreciation allowances worth about two-thirds to three-quarters of the current tax structure. It is sensitive to the inflation interest rate assumptions, but given reasonable——

Chairman LAFALCE. Two-thirds of the current. Do you have any idea what percentage it would be of pre-1981?

Mr. BRINNER. I believe I have a table. Rather than search for it——

Chairman LAFALCE. I mean, I think that was the cause of most of our problems, but——

Mr. BRINNER. Part of the current generosity is intentional. Part of it is accidental. As you are probably aware——

Chairman LAFALCE. Well, whether intentional or accidental, do you have any idea what it was before the accident, or before the intent?

Mr. BRINNER. I can look through here if you would like.

Chairman LAFALCE. All right, well, please proceed. We will pick that up later.

Mr. BRINNER. Fine.

All right, on this page, you then see that the Treasury plan would reduce these depreciation allowances. Now if you combine all of the features of the Treasury plan, then we can calculate the changes in the total cost of using capital. And, there, if we look at the last page of my exhibit, I think you can get a summary of this change in the total cost, because there are many factors.

Chairman LAFALCE. And that is page what—22?

Mr. BRINNER. Twenty-two, yes, that's correct.

Compared to a no tax world, you can see that because of the accelerated depreciation and the investment tax credits, the current system, in fact, provides a subsidy to equipment. If you look at the third to the last line, you see that the cost of capital is 95.7 percent of what it would be in a no tax world. That means that you have got a 4.3-percent subsidy to equipment.

If you look at the two lines above that, you see public utility structures enjoy approximately a 7-percent subsidy and non-public-utility structures have effectively a 25-percent tax.

Now if we move across to the last line of that table, you see the changes that would occur as we substitute this whole Treasury plan. Equipment would move to an 8-percent tax, 7.6. The non-public-utility structures, to a 22-percent tax. And the public utility to a 15-percent tax.

The conclusion is that——

Chairman LAFALCE. Again, do you have a table?

Mr. BRINNER. This compares it to the current system. You can see that.

Chairman LAFALCE. Yes; I understand that, but do you have a table that would compare it to the system?

Mr. **Brinner**. Yes.

Chairman **LaFalce**. Oh, you do have the 1980 system.

Mr. **Brinner**. Yes; the 1980 system there is the second column.

Chairman **LaFalce**. All right.

Mr. **Brinner**. And it does show you that it happens that equipment was neither taxed nor subsidized effectively.

Chairman **LaFalce**. It is 99.8, yes.

Mr. **Brinner**. And the same is true for the public utility structures. The non-public-utility structures had almost a 50-percent effective tax.

So, the current system did some equalization, actually.

Chairman **LaFalce**. Are you assuming all equity investment? Or, are you——

Mr. **Brinner**. This is assuming the actual mix of financing that is taking place in corporate America.

Chairman **LaFalce**. What is that?

Mr. **Brinner**. It is approximately 75 percent equity, 25 percent debt, except for the utilities, where we used 50–50. That is treating retained earnings as equity capital.

Chairman **LaFalce**. Thank you very much, Dr. Brinner. Does that conclude your remarks?

Mr. **Brinner**. No. There are just one or two others that I would like to make to give you some indication of how this would affect individual industries.

If you have moved to page 20, I include in this table the impact of the lower interest rates that would occur through the Treasury study. I draw your attention to the bottom of the table over on the righthand half. There, you see that, depending on the tax reform plan, equipment would have approximately a 6- to 11-percent higher cost under these different plans; nonutility structures, 7 to 12; utility structures, 2 to 11 percent.

None of the tax reform plans are going to dramatically change the cost of capital. You know, the ranges here are on the order of 5 to 10 percent. That is enough to depress capital investment, not enough to destroy it. The effects by industry, which was one of the questions that you raised in your invitation, are laid out on page 21. The differences between pages 20 and 21 are that page 20 tells you the type of equipment, page 21 tells you the industry using a broad range of equipment.

Chairman **LaFalce**. Let me just ask one simple question before we go on to the next person. Whenever you take a poll, there is always a margin of error, plus 5, minus 5 percent, you know, something like that, because of the fact that you have to use so many different sets of economic assumptions in your econometric model.

What's your margin of error either way?

Mr. **Brinner**. This actually isn't from Econometrics. This is just accounting. The only econometric estimate is the impact of the cost of funds.

Chairman **LaFalce**. All right, well—what would you say is your margin of error?

Mr. **Brinner**. Well, as I said, I tried to indicate that, 5 to 10. It's clear that it would be higher. It could be as much as 10 percent on average, it could be as little as 5 percent.

Chairman **LaFalce**. So your margin of error could be as much as 10 percent either way?

Mr. **Brinner**. No. I would say the margin of error is on the order of 2 to 3 percent. Say, the minimum of 5, a maximum of 10.

Chairman **LaFalce**. I see. Thank you.

Mr. **Brinner**. In conclusion, I would just like to indicate that I do, as an economist, believe the Treasury proposals are very solid translations of public and finance theory into tax legislation. It would treat investment more harshly, but that may be a tradeoff you are willing to make in order to get a greater public sense of fairness and equity.

Thank you very much.

[The prepared statement of Dr. Brinner on behalf of Data Resources, Inc., entitled "The Treasury Tax Proposal: Steps Toward Neutrality" follows:]

DRI Data Resources, Inc.

THE TREASURY TAX PROPOSAL: STEPS TOWARD NEUTRALITY

* * * * * * *

Presented by
Dr. Roger E. Brinner
Group Vice President
and Chief U.S. Economist
Data Resources, Inc.

* * * * * * *

Presented to the
U.S. House of Representatives
Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance and Urban Affairs
March 28, 1985

THE TREASURY TAX PROPOSAL: STEPS TOWARD NEUTRALITY

by Roger E. Brinner, Jesse M. Abraham, Robert A. Gough, and Judy B. Kosan

Over the past 20 years, Congress has frequently held hearings on the issue of basic tax reform. The lack of a coherent constituency, however, has stalled substantive action since reform would result in significant increases for specific taxpayer groups and only small cuts for the broad majority. Nevertheless, the Reagan Administration has chosen to take on this thankless task with its recent "Tax Reform for Fairness, Simplicity, and Economic Growth" proposal.

This study presents DRI's analysis of how the proposed tax reform plan would affect different sectors of society as well as the evolution of the economy over the next ten years. In particular,

- More people would be encouraged to join the labor force and to work longer hours. Married women in low- and middle-income households would account for most of this expansion in the labor force and in hours. The nation's potential market output would benefit from this larger labor supply from the home (where output is not counted in official GNP estimates) to industry.
- The personal tax cut and expanded pay-out of dividends would boost consumer expenditures. More generous shelters for retirement savings could help raise the personal saving rate, but the net effect would be higher consumption spending.
- Heavier post-tax mortgage payments due to lower marginal tax rates and heavier taxation of secondary residences would have a negative impact on homebuilding activity and housing prices. Unless the Federal Reserve changes its monetary growth targets, lower credit costs would only partially offset the damage to the housing market.
- Business would curtail capital spending due to higher after-tax bond costs, weaker share prices, repeal of the investment tax credit for equipment, less generous near-term depreciation allowances, and greater investor pressure for dividend pay-out.
- Output per hour would tend to be reduced by approximately 1% because of weaker total capital formation and a lower capital-labor ratio. A gain from more efficient allocation of capital could offset much of this loss in the long run.
- Total real spending would be slightly lower in the first four years after passage of the tax reform act, but then be slightly higher. The early weakness in demand, combined with a more rapidly expanding labor force, would reduce inflation pressures somewhat. This would eventually allow the Federal Reserve to hit its nominal money growth targets with a slightly more favorable split between real output and prices.
- The adverse effects on investment demand would retard growth and induce a gradual drop in interest rates. Within five years, both long- and short-term rates would be approximately two percentage points lower than in the baseline projection. The heavier corporate tax burden would nevertheless mean a 5-8% decline in the stock market.
- As an unintended but welcome byproduct of the proposal, the federal deficit would be cut by the lower interest rates, an effect which compounds substantially over time. Even though the plan is "revenue neutral,"

the tax proposal would lower the deficit by approximately $70 billion per year by the first half of the 1990s.

THE CURRENT TAX SYSTEM AND REFORM OBJECTIVES

In his 1984 State of the Union address, President Reagan directed the Treasury to prepare a plan for comprehensive reform of the nation's tax system. He specified only that the changes be "revenue neutral," i.e., that tax reform should not be used as a disguise for a tax increase, and that the plan must preserve the deductibility of mortgage interest payments on taxpayers' principal residences. Early last month, the Treasury fulfilled its mandate by delivering a sweeping tax reform proposal that complies with the President's specifications.

The primary goal of the Treasury's proposal is to reduce the role of taxation in private economic decisions. This represents a major change in philosophy: the current U.S. tax code has been extensively and explicitly designed to provide incentives for certain spending behavior. The tax system thus favors certain purchases (e.g., the investment tax credit for durable equipment) while opposing certain others (e.g., the alcohol and tobacco excise taxes). By eliminating many of these specific incentives, the Treasury plan would move the tax system closer to one ideal of economic efficiency.

Since the scope of the activities encouraged under current tax laws has been far greater than that of penalized activities, overall tax rates have had to be relatively higher in order to finance the large implicit subsidies. Under the Treasury proposal, however, the elimination of most preferential tax treatment would lower personal and corporate tax rates on each additional dollar of income. Thus, individuals with the same income but with different spending preferences would more likely pay the same taxes; corporations making investments of similar magnitude but in different industries would also be treated the same.

A secondary goal of the Treasury plan is to simplify U.S. income taxes. The proposal repeals or consolidates nearly 65 provisions in the tax code, eliminating the need for at least 16 personal tax forms. Simplification of the tax system implies less time and expense for both taxpayers and the Internal Revenue Service; it also would improve the equity of the system because individuals with greater knowledge of the intricacies of the tax code would no longer have as great an advantage.

THE TREASURY PROPOSAL

The Treasury plan represents a complete overhaul of the U.S. income tax system. For individuals, the proposal would lower tax rates and raise personal exemptions and zero bracket amounts, but repeal or modify a number of existing deductions, exclusions, and credits. For corporations, the Treasury proposes a lower statutory tax rate, along with elimination or change in preferential treatment of certain types of income and expense.

Individual incomes would fall into three rather than 15 tax brackets, with the bracket limits varying for single, head of household, and joint returns. The three new tax rates would be 15%, 25%, and 35%, compared with the current range of 11% to 50%. To provide additional relief for low income families, the taxpayer and all dependents would receive a personal exemption of $2,000 rather than $1,000; the standard

Table 1
The Proposed Personal Income Tax Brackets

	Single Returns	Head of Household Returns	Joint Returns
15% Rate Bracket...	0-$19,300	0-$25,000	0-$31,800
25% Rate Bracket...	$19,300-$38,100	$25,000-$48,000	$31,800-$63,800
35% Rate Bracket...	$38,100 or more	$48,000 or more	$63,800 or more
Zero Bracket Amount	$2,800	$3,500	$3,800

deduction, or zero-bracket amount, would also be raised.

Several itemized deductions, exclusions, and credits would be repealed in order to broaden the tax base. For those who itemize, the lower marginal rates and higher exemptions are designed to compensate for changes in deductibility. Specific measures include:

- limiting the deductibility of consumer interest payments (including mortgage interest on homes other than principal residences) to $5,000 in excess of investment income;
- limiting the deductibility of charitable contributions to the portion in excess of 2% of adjusted gross income (AGI);
- limiting the exclusion of employer-provided health insurance benefits to $70 per month for individuals and $175 per month for families;
- taxing only real capital gains by indexing the asset's base price to inflation;
- eliminating the deduction for all state and local taxes, including income and property taxes;
- eliminating the exclusion for unemployment compensation;
- eliminating the exclusion for employer-provided benefits such as group-term life insurance, educational benefits, and day care; and
- eliminating the two-earner deduction.

The Treasury plan retains the current treatment of medical expense deductions (above 5% of AGI) and of employer-provided pension and profit-sharing plans; it also expands the deduction for contributions to an IRA by raising the yearly limit from $2,000 to $2,500 for each worker, and from $2,250 to $5000 for a husband and wife with a single income.

The statutory tax rate for corporations would be reduced from 46% to 33% and the investment tax credit would be repealed. In addition, the Treasury proposes to replace the current Accelerated Cost Recovery System (ACRS) with a depreciation schedule that lengthens lifetimes and accounts for inflation in order to approximate economic depreciation more closely.

The tax proposal would also repeal several subsidies to specific industries. For example, the plan states that energy depletion, exploration and drilling costs, and intangible expenses are to be depreciated instead of expensed. Credit unions would no longer be tax-exempt; life insurance investment income and annuity income could no longer be deferred; and the special bad debt deduction for financial institutions would be eliminated.

New allowances are included, however, that tend to narrow the tax base: 50% of dividends paid out would be deductible from corporate income; indexation of inflation would be allowed for inventory accounting; and interest receipts (like expenses) would be indexed to inflation.

SECTORAL ANALYSIS

Analysis of such fundamental change in the tax system poses special challenges. The structure of the tax code conditions economic behavior in many intricate ways that a macroeconomic model cannot capture. For example, personal income tax rates not only determine government revenue but also affect an individual's willingness to work and to buy a home, as well as personal investment decisions. Calculating many of the potential changes from the Treasury tax reform plan thus entailed additional research to augment the structure of DRI's quarterly model.

Individual Taxpayers: Although the plan would reduce marginal tax rates significantly, the elimination of many current tax deductions means that the average tax burden would be only slightly lower (Table 2). Indeed, the Treasury proposal has specifically been designed to maintain the current tax distribution across broad subcategories. Over the longer run, however, the tax burden will likely shift somewhat toward the middle and lower income groups as upper income individuals cut back proportionately more on activities that are no longer subsidized.

Table 2
Estimated Average and Marginal Tax Rates
(Percent)

AGI, 1986$ (Thousands)	Average Tax Rates		Marginal Tax Rates	
	Current System	Treasury Proposal	Current System	Treasury Proposal
$0-14	4.0	1.6	7.4	5.2
$14-36	10.3	9.8	21.9	16.9
$36-57	13.8	14.6	31.4	25.5
$57-85	17.4	17.7	39.1	29.4
$85-142	21.0	22.4	44.9	35.0
$142+	37.2	27.2	50.0	35.0

Given approximately the same total tax burden, lower marginal tax rates will lead to an increased (post-tax) return on incremental work effort. Those already working may therefore want to increase their hours, while those currently outside the full-time, conventional labor force may decide that it is now worthwhile to seek regular employment. Based on a review of the professional literature on labor supply, our analysis suggests that the Treasury tax proposal could increase the desired hours of work by 2% and boost the labor force by 0.5%.

Table 3
Impact of the Tax Plan on Consumer Spending
(Percent change vs. base for constant dollar levels)

	Average 1986-90	Average 1990-95
Disposable Income	0.8	0.2
Consumption	0.4	0.3
Durables	1.3	1.8
Motor Vehicles and Parts	2.6	4.6
Furniture	0.5	0.1
Other	0.2	-0.4
Nondurables	0.3	-0.3
Food	0.3	0.0
Gas and Oil	0.4	0.7
Fuel Oil and Coal	0.6	0.0
Clothing and Shoes	0.4	-0.9
Other	0.1	-0.2
Services	0.2	0.1
Housing	-0.4	-0.2
Transportation	0.4	0.7
Household Operations	0.5	0.3
Electricity	0.0	0.0
Natural Gas	0.8	1.0
Other	0.7	0.3
Other	0.6	0.2

With average tax shares roughly the same, the plan would not affect the distribution of disposable income significantly. Since relative prices among goods are also not expected to change, the distribution of nondurable consumption spending should remain unchanged as well. Changes in the post-tax cost of interest, however, would tend to reduce spending on durables and housing; this negative impact would be offset by the 7% reduction in total personal taxes.

Residential Investment: The deductibility of interest payments on home mortgages and the failure to tax imputed rents provide a subsidy to homeownership that is largely capitalized into home prices. Although the Treasury proposal preserves full deductibility of mortgage interest for the taxpayer's principal residence and does not tax imputed rents, it does severely limit the deductibility of mortgage interest payments for second homes and no longer permits deduction of property taxes. Even on primary residences, the lower marginal tax rates reduce the value of the mortgage deduction, thus lowering the potential selling price of existing homes. On average, home prices are therefore expected to fall 12% initially (Table 4). Declining interest rates should eventually offset this effect, however, restoring home prices to the base case trajectory.

Stock Market: The Treasury tax plan makes a serious attempt to remove distortions in the capital markets caused by inflation and the current tax code. It therefore eliminates the current exclusion of 60% of long-term capital gains from taxable income; instead, nominal capital gains would be indexed to the price level

Table 4
The Movement in Home Prices

AGI, 1985$ (Thousands)	Median Home Price 1985$ (Thousands)	Annual Cost of Ownership (Dollars)	Home Prices (% Change) Unchanged (13%) Mortgage Rate	Home Prices (% Change) Changed (11%) Mortgage Rate
0-$14	35.0	4,123	0.0	9.7
$14-36	45.0	6,444	-7.5	4.2
$36-57	83.7	10,789	-10.9	1.0
$57-85	127.8	15,004	-17.4	-5.1
$85-142	206.2	29,827	-21.9	-7.5
$142+	384.0	38,784	-29.2	-14.0
Total			-12.0	0.7

so that only real gains would be subject to taxation. With 4% inflation and an average return and holding period, these two approaches are roughly equivalent. However, some enterprises, such as venture capital firms that realize large real gains over a very short period, would thus see their taxes rise significantly.

The Treasury plan also calls for an inflation adjustment of interest payments before permitting the deduction since only real interest (nominal interest less inflation) is a true "cost" to the firm or household. Assuming a 12% nominal interest rate, 5% inflation, and 33% corporate tax rate, the after-tax cost of debt would thus rise from 8.0% to 9.7%. Similarly, to the household facing a 24% average marginal rate under the new plan (vs. 32% under current law), the after-tax cost of a 12% mortgage would be 9% rather than 8%.

Finally, the double taxation of corporate income (once in the firm and once when distributed to individuals) would be reduced by allowing firms to deduct 50% of their dividends from their tax base. A dollar of after-tax earnings would cost the firm 16.5% less to pay out as dividends than under the current system: $1.00 today costs $1.00, given no deductibility; $1.00 under the Treasury proposal would generate a $.50 deduction. Assuming a 33% tax rate, this implies a tax reduction of $.165.

The immediate effect on stock prices from these changes will vary according to the firm's pay-out rate and the stockholder's holding period. While lower personal tax rates would on average increase the value of dividends (suggesting that prices would rise), the after-tax yield on bonds would also rise; combined with the higher overall corporate tax burden, this means a decline in the present value of post-tax dividends and retained earnings. For an "average" holding period of five years, the second effect would dominate, causing stock prices to fall roughly 8%.

Nonresidential Investment: In addition to the capital gains and interest treatment just discussed and numerous industry-specific provisions, the Treasury plan proposes other changes that would affect investment: reduction of the statutory corporate tax rate

Table 5
Effective Tax Rates on Realized Capital Gains
Under Current Law for 50% Bracket Taxpayer:
Constant 4% Real Rate of Return

Inflation Rate	Nominal Appreciation Rate (Percent)	Holding Period in Years 1	5	10
2	6	30.0	28.9	27.7
4	8	40.0	37.1	34.1
10	14	70.0	58.8	46.6

from 46% to 33%, elimination of the investment tax credit, and a lengthening of depreciation lifetimes.

The proposed depreciation rules, titled the Real Capital Recovery System (RCRS), specify seven asset classes, each with its own depreciation rate and close-out year. For example, property currently depreciated over three years would be depreciated on a declining balance basis at 32% per year for four years, with all residual value (21%) taken as a depreciation charge in the fifth year. The close-out period on five-year properties would range from 8 to 25 years; for public utility properties, it would be extended to 38 years. The depreciation lifetime for residential investment property, currently 18 years, would be raised to 63 years. The nominal basis would be indexed for inflation so that the total write-off could far exceed the initial investment. However, the discounted present value of depreciation allowances (assuming a 4% real return) is roughly equal to ACRS only with a 10% inflation rate.

Together, the statutory rate reduction and the lengthening of depreciation lifetimes would reduce the post-tax rental cost of capital by 2-5% for short-lived equipment (such as autos and computers), leave costs unchanged for medium-lived equipment (such as tractors and construction machinery), and increase costs 5-10% for other equipment. Loss of the investment tax credit would raise equipment capital costs over 10%, although lower interest rates would eventually offset part of this change. This occurs because lower real interest rates and lower equity costs not only reduce capital costs but also raise the present value of depreciation allowances.

Chart 1
The Average Post-Tax Cost of Using Equipment as a Percent of the Purchase Price

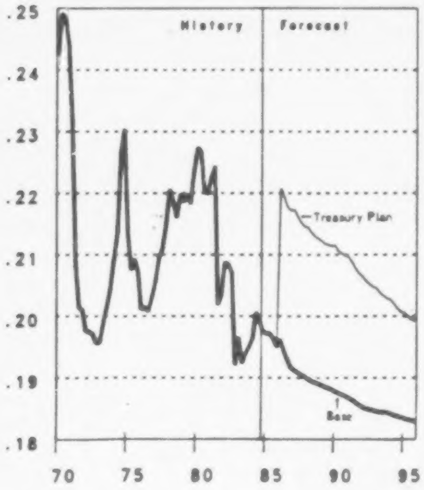
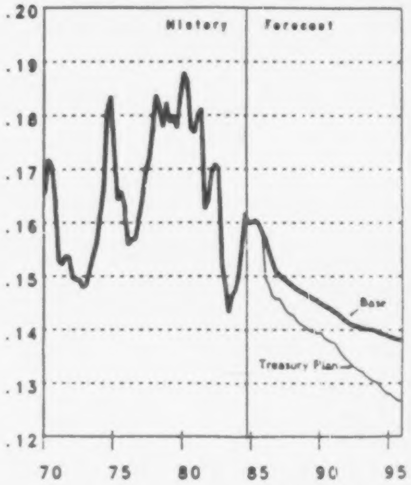


Chart 2
The Average Post-Tax Cost of Using Structures as a Percent of the Purchase Price



The transition from ACRS to RCRS for depreciation accounting would significantly reduce corporate cash flow. Since purchases contracted for before January 1986 would be covered under current law, an investment boom could occur in 1985 and a bust in 1986. These accounting changes would reduce consumption allowances by 10% in the first year, and 34% by the fifth year; corporate cash flow would thus be 14% lower (than with ACRS) in that fifth year.

Table 6
Corporate Capital Consumption Allowances

	1986	1989	1992	1995
Base Case..........	382.8	469.9	578.5	719.5
Treasury Plan.....	353.0	336.5	418.8	601.8
Difference........	-29.8	-133.5	-159.7	-117.6
Percent Difference	-7.8	-28.4	-27.6	-16.4

SIMULATION RESULTS

Although national output of goods and services would be slightly higher in the long run, GNP growth would slow initially when the tax reform is introduced (Table 7). The one exception is that the personal income tax cut would boost consumption, raising real GNP 0.1% above the baseline case in the first year. While the reduced deductibility of interest payments would cause a marked drop in interest rates after the first two years, this decline would only partially offset the increase in effective capital costs. Reduced capital consumption allowances would limit cash flow. The lower profitability of residential construction and reduced personal wealth from falling home prices would limit the demand for new homes.

Higher after-tax wages would boost the labor supply, immediately increasing potential output and putting deflationary pressures on wages and

Table 7
Impacts of the Treasury Tax Reform Proposal
(Percent difference from baseline unless otherwise indicated)

	86	87	88	89	90	91	92	93	94	95	86-89	90-95
Supply..............................												
Potential manhours.............	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Actual manhours................	0.0	-0.1	-0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.0	0.2
Business capital stock..........	0.0	-0.8	-1.8	-2.6	-2.9	-3.0	-2.9	-2.7	-2.4	-2.0	-1.4	-2.6
Number of homes................	-0.1	-0.3	-0.4	-0.4	-0.4	-0.3	-0.2	-0.2	-0.1	-0.1	-0.3	-0.2
Full-employment GNP............	0.4	1.0	1.2	1.1	0.9	0.8	0.7	0.6	0.6	0.6	0.9	0.7
Actual non-farm output per hour	-0.2	-0.3	-0.1	0.0	0.1	0.0	-0.1	-0.2	-0.3	-0.4	-0.1	-0.1
Demand..............................												
Consumer spending..............	0.4	0.6	0.4	0.4	0.4	0.4	0.3	0.2	0.2	0.2	0.4	0.3
Fixed investment...............	-0.9	-3.6	-4.6	-4.1	-2.5	-1.7	-1.1	-0.7	0.1	0.7	-3.4	-0.9
Residential...................	-4.3	-4.8	-2.3	0.9	3.7	5.1	5.3	4.4	3.6	2.7	-2.5	4.1
Nonresidential................	0.0	-3.3	-5.2	-5.4	-4.0	-3.3	-2.6	-1.8	-0.7	0.3	-3.6	-2.0
Equipment....................	-0.2	-4.3	-6.3	-6.2	-4.1	-3.4	-2.5	-1.6	-0.6	0.2	-4.3	-2.0
Structures...................	0.3	-0.9	-2.2	-3.2	-3.6	-3.1	-2.8	-2.3	-1.0	0.7	-1.6	-2.0
Real GNP.........................	0.1	-0.1	-0.3	-0.2	0.2	0.4	0.4	0.4	0.5	0.5	-0.1	0.4
Wages and Prices..................												
Hourly wages....................	0.0	-0.2	-0.7	-1.2	-1.7	-2.1	-2.4	-2.6	-2.7	-2.7	-0.6	-2.4
Consumer prices.................	0.0	0.0	-0.2	-0.5	-0.8	-1.0	-1.1	-1.1	-1.0	-0.8	-0.2	-0.9
Real wages......................	-0.1	-0.3	-0.5	-0.7	-0.9	-1.2	-1.4	-1.6	-1.8	-2.0	-0.4	-1.5
Wholesale industrial prices....	0.0	0.1	-0.2	-0.7	-0.9	-0.9	-0.8	-0.5	-0.2	0.2	-0.2	-0.5
Financial Conditions..............												
Standard&Poor 500 index........	-8.0	-6.6	-6.1	-5.4	-5.1	-5.4	-5.9	-6.3	-6.7	-6.7	-6.4	-6.1
Dividend yield*...............	0.30	0.56	0.66	0.63	0.51	0.49	0.62	0.96	1.35	1.74	0.54	0.94
Prime rate*.....................	0.00	-0.24	-0.79	-1.34	-1.74	-1.86	-1.86	-1.76	-1.61	-1.41	-0.60	-1.70
Mortgage rate*..................	-0.21	-0.34	-0.56	-0.88	-1.22	-1.52	-1.80	-1.95	-2.06	-2.16	-0.50	-1.79
Corporate bond rate*...........	-0.45	-0.59	-0.89	-1.25	-1.60	-1.87	-2.11	-2.20	-2.27	-2.36	-0.80	-2.07
Post-tax cash flow..............	-7.9	-10.4	-10.7	-11.6	-12.5	-10.6	-8.9	-6.2	-5.7	-4.9	-10.3	-7.8
Other Indicators..................												
Unemployment rate*.............	0.1	0.4	0.6	0.5	0.3	0.2	0.1	0.1	0.1	0.0	0.4	0.1
Employment......................	0.0	-0.3	-0.5	-0.4	-0.1	0.1	0.3	0.4	0.4	0.4	-0.3	0.3
Industrial production..........	0.2	-0.7	-1.0	-0.4	0.8	1.3	1.6	1.6	1.5	1.5	-0.5	1.4
Capacity utilization rate*.....	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Federal Budget....................												
Taxes**.........................	1	-2	3	5	15	9	3	-11	-13	-15	2	-2
Personal**....................	-25	-34	-30	-38	-45	-51	-57	-61	-63	-64	-32	-57
Corporate**...................	25	31	34	47	64	64	63	51	48	47	34	54
Expenditures**..................	1	0	-5	-18	-35	-52	-67	-79	-87	-93	-6	-69
Interest**....................	0	-2	-7	-15	-27	-40	-53	-63	-73	-80	-6	-56
Deficit**.........................	0	-3	8	23	51	62	70	68	74	78	7	67

Chart 3
Real Components of GNP
(Percent change relative to base)

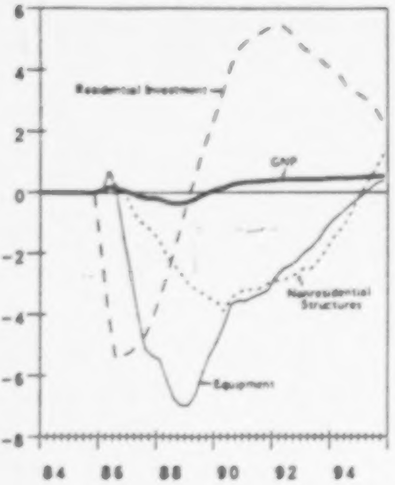
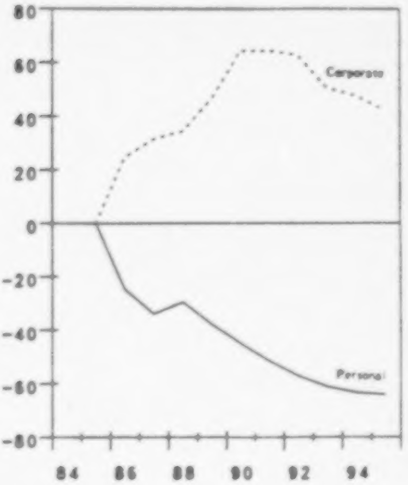


Chart 4
Tax Receipts
(Difference from baseline, billions of dollars)



prices. Over a 10-year period, average hourly wages would fall 3% below the base case trajectory. Prices would not fall as much because the falling exchange rate in a lower interest rate environment would raise import prices.

Lower wages and higher capital costs would change the optimal mix of capital and labor in national production. Within six years, the Treasury plan would lower the business capital stock by 3%, reducing productivity per man-hour. After 10 years, investment would recover to the baseline level, leaving the capital stock only 2% lower than the base case.

The Treasury tax proposal is not intended to be a vehicle for reducing the deficit; it was designed to be revenue neutral in the aggregate. For the first five years, the proposed system would in fact raise the same revenues as the current system; as capital consumption allowances grow, however, corporate tax receipts decline, lowering revenues roughly 1-2% during the 1990s. The deficit nevertheless declines significantly due to the savings on interest payments.

CONCLUSION

The Treasury proposals are solid translations of public finance theory into tax legislation; the sole exception to this is the treatment of homeownership. Relative to current law, however, the plan would treat all investment more harshly. The result, then, would be a loss in near-term economic output and a long-term decline in the capital-labor ratio. This would only be partially offset by potential improvements in the efficiency of capital allocation (see Appendix for quantitative estimates). Only after five or more years would the lower interest rates and inflation adjustments be likely to induce stronger investment.

The question must be asked whether the current economic climate is an appropriate one in which to introduce such a set of changes. The federal deficit will exceed $200 billion this year and $300 billion by the early 1990s unless expenditures are cut or taxes increased. In the face of conservative monetary policy, this borrowing pressure has led to unprecedentedly high interest rates relative to inflation. The growth recession now in progress is a direct consequence of this fiscal/monetary policy mix. This is not a healthy environment for fixed investment. Without the strong countervailing tax incentives of the 1981 ERTA legislation, business fixed investment would be dismal today.

Should Congress address tax reform before dealing with the deficit? Probably not, given the major risk of reducing per capita living standards due to sagging investment; the deficit is a problem precisely because it already threatens to produce such results. At the very least, Congress should debate tax reform and deficit correction simultaneously.

APPENDIX: ESTIMATING THE MAXIMUM EFFICIENCY GAINS FROM AN OPTIMAL REALLOCATION OF THE NATION'S CAPITAL STOCK

One of the arguments that the Treasury uses to support its tax reform plan is that gains will accrue from more efficient allocation of the national savings pool. Without pretending to provide an exhaustive analysis, DRI constructed aggregate, multi-factor production function models to estimate just how large these benefits would be. Despite rather substantial potential reallocations of the capital stock, the percentage gains in output would be small: as little as 0.1% of GNP ($3 billion using 1984 as a base), up to 0.9% of GNP ($33 billion).

The range of estimates is based on alternative assumptions about the elasticity of substitution among types of capital and labor in the aggregate production function, and about the tax rates in effect as the current capital stock was being accumulated. In all cases, the "current" environment was then compared to a completely neutral environment.

Naturally, the gains from the Treasury plan will be greater, the greater is the distortion in current law and the stronger are the factor substitution possibilities assumed within the production function.

Table A.1
Long-Run Efficiency Gains
As a Percent of Base GNP

Reduction in Tax Distortion	Factor Substitution Potential*	
	High	Low
High	0.9%	0.5%
Moderate	0.7%	0.3%
Low	0.2%	0.1%

Factor Substitution: A CES production function* of the form

$$Q \doteq (.1K_1^{-B}, + .1K_2^{-B} + .1K_3^{-B} + .7L^{-B})^{-1/B}$$

was assumed. K_1, K_2, and K_3 represent residential structure, producers' durable equipment, and nonresidential structure capital stocks. As is typical in such aggregate analyses, labor has a 70% share of total product. "High" factor substitution implies a 1.0 elasticity, "low" factor substitution has a 0.5 elasticity. The factor exponent in the production function is related to the elasticity of substitution, S, by the following formula: $B=1/S - 1$. (The CES function collapses to the familiar Cobb-Douglas form when the elasticity of substitution equals 1.)

Tax Distortion: Given the 1982 law and economic parameters, Fullerton and Henderson** have estimated the total effective tax rates on these three capital stocks as 18.6% for owner-occupied housing, 0.4% for producers' durable equipment, and 37.7% for nonresidential, nonutility structures.

If the Treasury plan did not provide preferential treatment for owner-occupied housing, these tax rates could have been fully equalized. This extreme assumption is used in establishing efficiency gains. Since the total capital stock is assumed to be fixed, the exact level of rates is not important; only relative tax rates matter. In this illustration, we use 20% as the tax rate.

Maximum efficiency gains are calculated by comparing output assuming equal tax rates with output assuming alternative characterizations of the 1982 tax structure. This procedure tends to overstate gains because the current capital stock was put in place under a less biased system than has existed since 1981, and because the Treasury plan does not fully equalize tax rates. On the other hand, there may be some offsetting tendency toward understatement because substantial differences exist today within each of the three classes of capital stock. The Treasury proposal would eliminate much of this intra-class inefficiency.

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*Source: R.G.D. Allen, Macroeconomic Theory New York: St. Martin's Press, Inc., 1967).

**Don Fullerton and Yolanda Kodrzycki Henderson, "Incentive Effects of Taxes on Income from Capital." National Bureau of Economic Research, Working Paper No. 1262, January 1984.

The "moderate" line in the tax distortion spectrum of Table A.1 makes no adjustment for either of these tendencies. The "high" line assumes that the effective tax rates under which the current capital stock has been accumulated were 10%, 15%, and 40%; this provides a very generous estimate of gains from reducing both cross-class and within-class distortions. Conversely, the "low" line assumes that the three effective tax rates were 10%, 20%, and 30%, a less distorted spectrum.

It is important to recognize that the lags occur between changes in the laws and achievement of efficiency gains: the entire capital stock, not just current investment flows, must be reallocated. Such lags are measured in decades, not years. Thus, the average annual change in the national productivity growth rate is equal to the estimated efficiency gain divided by this lag. With ten years used as a very generous assumption here, the annual improvement in the national growth rate could be at most 0.1% (the 0.9% maximum long-term gain divided by 10).

Moreover, as our analysis has pointed out, the shift of the tax burden from personal to corporate incomes is likely to reduce the national savings pool and hence the capital stock. In 1995, the business capital stock is projected to be 2.0% lower and the residential stock 0.1% lower. This would cut potential national output by approximately 0.5%, offsetting the efficiency gains. The only gain to potential GNP would thus derive from a shift of hours from work at home and leisure into hours employed, which is then captured in the official GNP accounts.

Table A.2
Capital Allocation under Alternative Tax Regimes

	"Current" Tax Regime Characterization			Fully Neutral Regime
	Low Distortion	Moderate Distortion	High Distortion	
Capital Tax Rate				
T_1	[illegible]	[illegible]	[illegible]	[illegible]
T_2	[illegible]	[illegible]	[illegible]	[illegible]
T_3	[illegible]	[illegible]	[illegible]	[illegible]
Capital Stock*				
A. Elasticity of Substitution = 1.0				
K_1 "Owner-Occ. Housing"	[illegible]	[illegible]	[illegible]	100
K_2 "Producer Dur. Equip."	[illegible]	[illegible]	[illegible]	100
K_3 "Nonres. Structures"	[illegible]	[illegible]	[illegible]	100
B. Elasticity of Substitution = 0.5				
K_1	[illegible]	[illegible]	[illegible]	100
K_2	[illegible]	[illegible]	[illegible]	100
K_3	[illegible]	[illegible]	[illegible]	100

*Total capital stock assumed fixed at 300 "units."

The Leverage of Alternative Tax Stimuli to Investment
(Excluding feedback effects)

	Increased Investment Tax Credit[1]	Lower Statutory Corp. Tax Rate[2]	Enhanced R&D Tax Credit[3]	50% Dividend Deductibility[4]	Full New Issue Div. Deduct.[5]
Average Annual Impact ($Billion, Years 1-10)					
Corp. Tax Liability	-47.6	-40.1	-8.5	-38.7	2.6
Nonres. Investment	44.0	19.9	3.3	15.7	1.7
R&D Spending	1.6	0.1	6.0	2.7	0.3
Investment "Bang-for-the-Buck"	0.95	0.50	1.47	0.94	0.83
Productivity Gain (%increase, 10th year)	1.0	0.6	0.4	0.7	0.1
Potential GNP Gain ($ per capita,10th year,1984 prices)	117	65	41	78	9

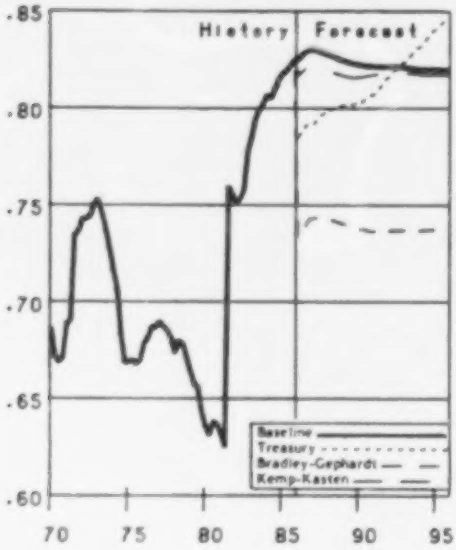
[1] Increase in maximum rate of credit from 10% to 19%, designed to give a static revenue loss of $25 billion initially.
[2] Reduction in statutory federal corporate tax rate from 46% to 33%, also designed to give an initial $25 billion static revenue loss.
[3] Expansion of the 25 R&D tax credit to apply to all spending above a fixed base, rather than above a rolling base as under current law.
[4] Provision allowing deduction of 50% of corporate dividends from taxable corporate income.
[5] Provision allowing full deductibility of all dividends paid on new issues of corporate stock only.

TAX TREATMENT OF DEPRECIATION

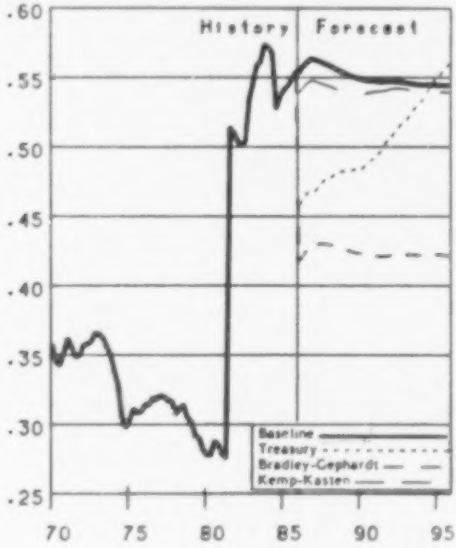
Important Tax Parameters by Type of Investment Good

	ACRS Lifetime	ADR Lifetime	Current ITC	Treasury Closeout (years)	Treasury Depreciation Rate	Economic Depreciation Rate
Furniture and Fixtures	4.5	8.00	.10	17	.12	.110
Fabricated Metal Products	4.5	10.00	.10	17	.12	.093
Engines and Turbines	4.5	12.48	.10	25	.08	.080
Tractors	4.5	5.00	.10	12	.18	.220
Agricultural Machinery	4.5	8.00	.10	17	.12	.100
Construction Machinery	4.5	7.92	.10	12	.18	.200
Mining & Oil Field Mech.	4.5	7.68	.10	12	.18	.150
Metalworking Machinery	4.5	10.18	.10	17	.12	.107
Special Industrial Machinery	4.5	10.16	.10	17	.12	.113
General Industrial Machinery	4.5	9.84	.10	17	.12	.116
Office & Computing Machinery	4.5	8.00	.10	8	.24	.190
Service Industry Machinery	4.5	8.24	.10	12	.18	.170
Electrical Machinery	4.5	9.92	.10	17	.12	.112
Trucks, Busses & Trailers	4.5	5.00	.10	8	.24	.200
Automobiles	2.5	3.00	.06	5	.32	.190
Aircraft	4.5	7.00	.10	12	.18	.110
Ships and Boats	4.5	14.4	.10	25	.08	.070
Railroad Equipment	4.5	12.00	.10	25	.08	.070
Instruments	4.5	8.40	.10	12	.18	.140
Other Equipment	4.5	8.16	.10	17	.12	.150
Public Utility Structures	12.0	21.4	.10	30	.05	.062
Nonpublic Utility Structures	13.9	33.4	0	63	.03	.054

The Discounted Present Value of One Dollar of Depreciation of Producers' Durable Equipment (Dollars)



The Discounted Present Value of One Dollar of Depreciation of Nonpublic Utility Structures (Dollars)



RCRS Asset Classes

RCRS Class	Depreciation Rate	Classification of ACRS Property	Close-Out Period (Years)[2]
Class 1	32%	3-year property	5
Class 2 (5 Year ACRS)	24%	Trucks, Buses and Trailers, Office Computing and Accounting Equipment	8
Class 3 (5 Year ACRS)	18%	Construction Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, Instruments	12
Class 4 (5 Year ACRS)	12%	5-year property not assigned to Class 2, 3 or 5 including Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Electrical Transmission/Distribution Equipment, Communications Equipment, Fabricated Metal Products	17
Class 5 (5 Year ACRS)	8%	Railroad Equipment, Ships and Boats, Engines and Turbines	25
Class 6	5%	10-year property; 15-year public utility property	38
Class 7	3%	18-year property; 15-year low-income housing	63

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Office of Tax Analysis

[1] Items of property are assigned to RCRS classes under rules described in the text of the General Explanation.

[2] The close-out year is the year in which 15 percent of the inflation-adjusted original basis remains to be depreciated.

The After-Tax Value of Depreciation Allowances Including Recapture, by Asset Ciass and Inflation Rate*
(Per $1,000 investment)

Treasury Asset Class	Holding Period/ Depreciation Rate	CURRENT SYSTEM 0% Inflation	CURRENT SYSTEM 5% Inflation	CURRENT SYSTEM 10% Inflation	TREASURY 0% Inflation	TREASURY 5% Inflation	TREASURY 10% Inflation	TREASURY AS A FRACTION OF CURRENT SYSTEM 0% Inflation	TREASURY AS A FRACTION OF CURRENT SYSTEM 5% Inflation	TREASURY AS A FRACTION OF CURRENT SYSTEM 10% Inflation
1	3 years/.32									
	Nominal Total	316	293	267	202	213	223	0.64	0.73	0.83
	Inflation Adjusted Total	316	292	270	202	202	202	0.64	0.69	0.75
	Present Value	312	290	268	194	194	195	0.62	0.67	0.73
2	5 years/.24									
	Nominal Total	343	310	272	233	255	279	0.68	0.82	1.03
	Inflation Adjusted Total	343	299	249	233	233	233	0.68	0.78	0.93
	Present Value	328	288	255	217	218	219	0.66	0.76	0.86
3	5 years/.18									
	Nominal Total	289	242	185	194	214	235	0.67	0.88	1.27
	Inflation Adjusted Total	289	245	195	194	194	194	0.67	0.79	0.99
	Present Value	284	243	210	181	181	182	0.64	0.74	0.87
4	5 years/.12									
	Nominal Total	217	150	69	144	159	176	0.66	1.06	2.55
	Inflation Adjusted Total	217	173	123	144	144	144	0.66	1.20	1.17
	Present Value	224	184	150	133	134	134	0.59	0.73	0.89
5	5 years/.08									
	Nominal Total	157	73	-17	103	114	127	0.66	1.56	nm
	Inflation Adjusted Total	157	113	70	103	103	103	0.66	0.91	1.47
	Present Value	175	133	106	95	95	96	0.54	0.71	0.91
6	10 years/.05									
	Nominal Total	184	11	-153	127	159	199	0.69	14.45	nm
	Inflation Adjusted Total	184	101	85	127	127	127	0.69	1.15	1.49
	Present Value	205	136	112	108	109	110	0.53	0.80	0.98
7	19 years/.03									
	Nominal Total	305	69	-487	136	207	327	0.45	3.00	nm
	Inflation Adjusted Total	305	151	154	136	136	136	0.45	0.90	0.88
	Present Value	259	155	95	102	103	104	0.39	0.66	1.09

*This table supplements Tables 4-10 in the second volume of the Treasury Proposal. The total after-tax value of depreciation provisions, including recapture, in current dollars, inflation-adjusted dollars, and the present value (assuming a 4% real rate of return) is reported for each asset class for the designated holding period. It is assumed that the Treasury proposal depreciation rates are the true economic depreciation rates, so there is no recapture under the Treasury proposal. Eighteen-year property is assumed to be held for 19 years, using a straight-line method.
nm: Not meaningful.

Source: DRI computations.

The Number of Years Asset Must be Held under the Treasury Proposal in Order to Receive the Same Present Value of Depreciation Allowances as under ACRS*

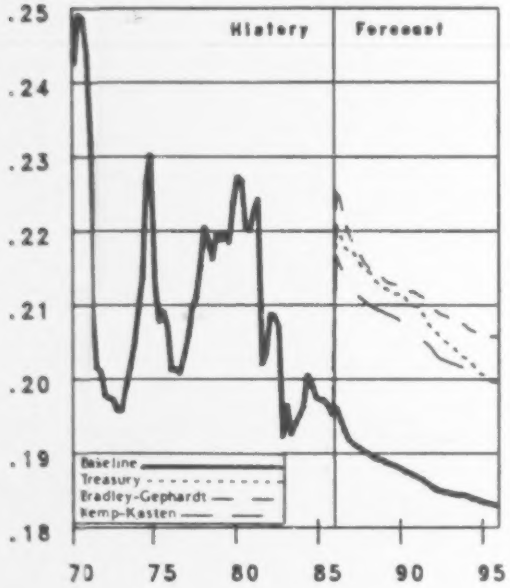
New Asset Class	0% Inflation	8% Inflation	10% Inflation
1	a	5	5
2	a	8	7
3	a	a	11
4	a	a	17
5	a	a	a
6	a	a	38
7	a	a	63

a Even when asset is fully depreciated, the present value remains less than with ACRS.

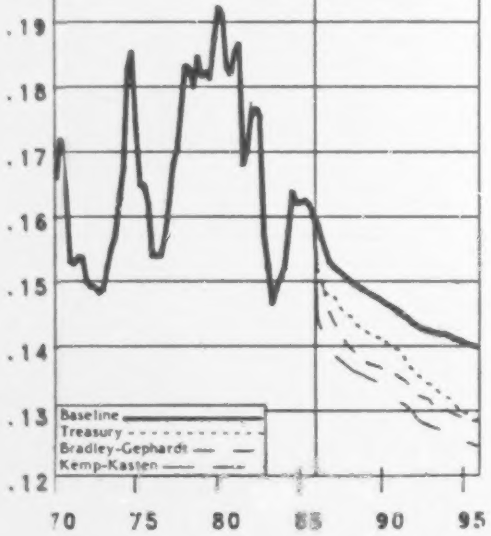
*Calculations assume a 4% real rate of return. The methodology corresponds to that used for Tables 4-10 in the second volume of the Treasury Proposal.

Source: DRI computations.

The Average Post-Tax Cost of Using
Equipment Under Different Tax Regimes
As a Percent of the Purchase Price



The Average Post-Tax Cost of Using Non-Public Utility
Structures Under Different Tax Regimes
As a Percent of the Purchase Price



The Annual Post-Tax Cost of Using Capital Under Different Tax Regimes as a Percent of the Purchase Price*

	Current System	Bradley-Gephardt	Kemp-Kasten	Treasury
Furniture and Fixtures	16.8	19.4	18.6	19.8
Fabricated Metal Products	15.1	17.5	16.7	17.7
Engines and Turbines	13.7	17.0	15.3	17.1
Tractors	28.1	29.9	30.8	31.5
Agricultural Machinery	15.8	18.3	17.5	18.6
Construction Machinery	26.1	29.9	28.6	29.2
Mining & Oil Field Machinery	20.1	24.1	23.0	23.5
Metalworking Machinery	16.5	19.1	18.3	19.4
Special Industrial Machinery	17.1	19.8	18.9	20.1
General Industrial Machinery	17.4	20.1	19.3	20.5
Office & Computing Machinery	25.0	28.7	27.4	27.2
Service Industry Machinery	23.0	26.4	25.2	25.8
Electrical Machinery	17.0	19.7	18.8	20.0
Trucks, Buses & Trailers	26.1	28.5	28.6	28.3
Automobiles	24.7	26.6	26.3	26.5
Aircraft	16.8	18.6	18.6	18.9
Ships and Boats	12.7	15.8	14.2	15.8
Railroad Equipment	12.7	15.8	14.2	15.8
Instruments	19.9	22.9	21.9	22.3
Other Equipment	20.9	24.1	23.0	24.6
Public Utility Structures	12.7	14.6	14.1	15.8
Non-Public Utility Structures	15.3	14.8	13.8	14.9
All Equipment	21.5	24.4	23.6	24.1
All Structures	14.7	14.8	13.9	15.1

*Constant interest rates. See Figure A.3.2.1 for variable inputs.

The Annual Post-Tax Cost of Using Capital Under Different Tax Regimes Relative to the Current System

	CURRENT COST OF FUNDS			LOWER COST OF FUNDS*		
	Bradley-Gephardt	Kemp-Kasten	Treasury	Bradley-Gephardt	Kemp-Kasten	Treasury
Furniture & Fixtures	1.156	1.105	1.176	1.125	1.091	1.088
Fabricated Metal Products	1.159	1.109	1.176	1.126	1.094	1.085
Engines & Turbines	1.239	1.112	1.241	1.201	1.097	1.134
Tractors	1.062	1.094	1.121	1.041	1.082	1.056
Agricultural Machinery	1.158	1.107	1.176	1.125	1.093	1.086
Construction	1.145	1.096	1.121	1.122	1.083	1.055
Mining & Oil Field Machinery	1.150	1.100	1.122	1.123	1.087	1.052
Metalworking Machinery	1.156	1.106	1.176	1.125	1.092	1.087
Special Industrial Machinery	1.155	1.105	1.175	1.124	1.091	1.088
General Industrial Machinery	1.155	1.104	1.175	1.124	1.090	1.088
Office & Computing Machinery	1.146	1.096	1.088	1.122	1.084	1.030
Service Industry Machinery	1.148	1.098	1.122	1.122	1.085	1.054
Electrical Machinery	1.155	1.105	1.175	1.125	1.091	1.088
Trucks, Buses & Trailers	1.094	1.096	1.087	1.071	1.083	1.030
Automobiles	1.076	1.065	1.071	1.057	1.055	1.024
Aircraft	1.104	1.105	1.123	1.074	1.091	1.048
Ships and Boats	1.242	1.114	1.242	1.202	1.099	1.132
Railroad Equipment	1.242	1.114	1.242	1.202	1.099	1.132
Instruments	1.151	1.101	1.122	1.123	1.088	1.051
Other Equipment	1.150	1.100	1.174	1.123	1.087	1.092
Public Utility Structures	1.143	1.102	1.241	1.022	1.069	1.105
Non-Public Utility Structures	.971	.906	.980	.931	.888	.882
All Equipment	1.137	1.098	1.126	1.110	1.083	1.056
All Structures	1.012	.953	1.043	.953	.931	.936

*Lower cost of funds calculations are based on the cost of funds in each simulation in the final quarter of 1995. Interest rates are 230 basis points lower than baseline in Treasury, 380 lower in Bradley-Gephardt, and 180 lower in Kemp-Kasten.

The Annual Post-Tax Cost of Using Capital Under Different Tax Regimes Relative to the Current System

	Current Cost of Funds			Lower Cost of Funds		
	Bradley-Gephardt	Kemp-Kasten	Treasury	Bradley-Gephardt	Kemp-Kasten	Treasury
Stone, Clay and Glass Products	1.141	1.100	1.143	1.114	1.079	1.061
Primary Metal Industries	1.147	1.101	1.154	1.118	1.087	1.074
Fabricated Metal Products	1.142	1.105	1.145	1.114	1.092	1.070
Machinery Except Electrical	1.146	1.103	1.145	1.117	1.089	1.069
Electrical Machinery	1.142	1.098	1.144	1.114	1.084	1.066
Transportation Equipment	1.149	1.102	1.156	1.120	1.088	1.075
Motor Vehicles	1.152	1.103	1.162	1.122	1.089	1.079
Aircraft and Missles	1.123	1.089	1.127	1.105	1.076	1.051
Other Transportation Equipment	1.148	1.102	1.151	1.119	1.088	1.072
Other Durables	1.126	1.095	1.128	1.100	1.082	1.057
Food and Beverages	1.109	1.073	1.113	1.082	1.060	1.040
Textile Products	1.132	1.087	1.142	1.103	1.074	1.062
Paper and Allied Products	1.148	1.101	1.155	1.119	1.087	1.074
Chemicals and Allied Products	1.128	1.083	1.131	1.099	1.070	1.052
Petroleum and Coal Products	1.138	1.099	1.139	1.110	1.086	1.064
Rubber and Plastics Products	1.146	1.100	1.151	1.117	1.086	1.071
Other Nondurables	1.137	1.096	1.140	1.110	1.083	1.064
Mining	1.134	1.117	1.131	1.110	1.104	1.075
Trade and Services	1.116	1.091	1.108	1.092	1.078	1.045
Railroad Transportation	1.212	1.107	1.209	1.176	1.092	1.110
Air Transportation	1.107	1.100	1.120	1.078	1.086	1.047
Transportation excl. Rail and Air	1.102	1.085	1.096	1.079	1.073	1.037
Communication	1.151	1.103	1.165	1.121	1.089	1.081
Public Utilities	1.153	1.100	1.151	1.124	1.086	1.072
Other	1.112	1.094	1.133	1.087	1.081	1.062

The Annual Post-Tax Cost of Using Capital Under Different Tax Regimes Relative to a No-Tax World*

	Current System	1980 System	Bradley-Gephardt	Kemp-Kasten	Treasury
Furniture and Fixtures	.943	.978	1.080	1.043	1.109
Fabricated Metal Products	.935	1.014	1.083	1.036	1.099
Engines and Turbines	.927	1.054	1.148	1.030	1.150
Tractors	.975	.993	1.036	1.067	1.093
Agricultural Machinery	.938	.973	1.086	1.039	1.103
Construction Machinery	.971	1.005	1.113	1.064	1.089
Mining & Oil Field Machinery	.959	.986	1.102	1.054	1.076
Metalworking Machinery	.942	1.025	1.089	1.042	1.107
Special Industrial Machinery	.944	1.028	1.091	1.044	1.110
General Industrial Machinery	.945	1.023	1.092	1.045	1.112
Office & Computing Machinery	.969	.979	1.111	1.063	1.054
Service Industry Machinery	.964	1.005	1.107	1.059	1.082
Electrical Machinery	.944	1.022	1.091	1.044	1.110
Trucks, Buses & Trailers	.971	.989	1.062	1.064	1.056
Automobiles	.958	.989	1.031	1.020	1.026
Aircraft	.943	.953	1.041	1.043	1.060
Ships and Boats	.919	1.079	1.142	1.024	1.142
Railroad Equipment	.919	1.037	1.142	1.024	1.142
Instruments	.955	1.002	1.100	1.052	1.072
Other Equipment	.939	.997	1.102	1.054	1.126
Public Utility Structures	.926	.993	1.059	1.021	1.149
Non-public Util. Structures	1.249	1.487	1.213	1.132	1.224
All Equipment	.957	.998	1.087	1.049	1.076
All Structures	1.171	1.368	1.176	1.105	1.206
Weighted Standard Deviation	.029	.047	.013	.009	.015

*The nominal interest rate, inflation rate, and return on equity are all held constant. No-tax regime is defined as a zero tax on capital income and a zero investment tax credit

Chairman **LaFalce**. Thank you very much, Dr. Brinner.

Our next witness, the gentleman that I had the pleasure of having appear on two panels before, about a month or so ago—one in Rochester, one in Buffalo—Paul R. Huard, vice president, taxation and fiscal policy, the National Association of Manufacturers.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT FOR TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS [NAM]

Mr. **Huard**. Thank you, Mr. Chairman. Nice to see you again. I will try and summarize what is in the statement in relatively short order.

As you are no doubt aware, we have said a number of relatively negative things about the Treasury's reform plan, mostly focusing on the fact that it is not a pro-growth plan.

Chairman **LaFalce**. Was a lot of that based upon Wharton Econometrics' original opinion?

Mr. **Huard**. That is correct.

Chairman **LaFalce**. Now that Wharton Econometrics has changed their opinion, have you changed yours?

Mr. **Huard**. No; we don't think their second opinion is as good as their first, and I will get to that.

Chairman **LaFalce**. All right. Good.

Mr. **Huard**. But, at the outset, because of the fact that we are sort of almost notorious in criticizing certain elements of the Treasury plan, particularly the effect on investment and productivity and competitiveness, I would like to point out NAM very strongly supports the need for reform and simplification of the Federal income tax laws.

Chairman **LaFalce**. You do? I was under the impression from the Washington Post, March 12, 1985, quote:

"The NAM has no official position on tax simplification."

Are you telling the Washington Post they are wrong?

Mr. **Huard**. Yes; that is Ann Woodsen's article. I don't believe——

Chairman **LaFalce**. Are you telling Ann she was wrong?

Mr. **Huard**. I don't believe everything I read in the Post.

Chairman **LaFalce**. All right.

Mr. **Huard**. Particularly when it is Bob McIntyre. We do support the need for reform and simplification. We do support a number of the important concepts that are in the Treasury plan, such as corporate rate reduction, minimize the gregious disparities in effective corporate tax rates that presently exist, dividend deductibility to mitigate the problem of double taxation of corporate earnings paid out to shareholders.

But it is also fair to say that we support those provisions because they are sound tax policy that stand on their own merits, not because of the plan where they happened to be contained.

Moving to the Treasury plan, as you know, the Wharton study that we commissioned a number of months ago indicated that essentially that as the real GNP as opposed to nominal, there would be no real growth in the Treasury plan, there would be pretty much across-the-board increases in the user cost of capital. There would be lower productivity, lower business investment.

The second Wharton study, which I have had the privilege to read, varies some of those results based largely on changes in assumptions relating to dividend, deductibility, and interest rates.

I don't think, frankly, the changes in assumptions are correct. I think dividend deductibility is probably implausible.

Chairman **LaFalce**. This is more in jest than anything else, but it is on my mind. Do you have any idea who paid them for the first study and who paid them for the second study?

Mr. **Huard**. I don't know. We paid them for the first one but it was a standard off-the-shelf study. We didn't tell them—I have heard people say that——

Chairman **LaFalce**. No, no, no, it's just a——

Mr. **Huard**. We suggested they take——

Chairman **LaFalce**. You always wonder about things like that.

Mr. **Huard**. I don't know who paid for the second one. It is an interesting question, though. I would like to find out.

Chairman **LaFalce**. But we do know who paid them for the first.

Mr. **Huard**. That is right.

I think on dividend deductibility there is at least an equally plausible argument that that would lead to weaker capital formation due to the increased pressure to pay out dividends.

On interest rates, I don't think there is any clearer proof that the Treasury tax reform plan would lead to lower interest rates. I think there is an assumption, I guess, that Wharton made, that you have adjustments for inflation and lower after-tax—or higher after-tax rate of return, then interest rates will come down.

Certainly, historically, lowering tax rates has not correlated with lower interest rates. You look at the pattern of the 3-year, 1981 tax cuts, and it didn't correlate.

And, indeed, in Wharton's testimony before this subcommittee they were very hesitant to actually claim that it would happen. They said they thought it might happen and they, indeed, provided you with two sets of tables and hedged their comment a lot.

So I am not too sure that their second study was all that convincing a departure from the first.

I think one of the problems with all of the studies is that they perhaps don't have any way to account for what might happen in the real world.

One of our biggest concerns with the type of approach the Treasury tax reform plan takes is how you get from here to there, particularly over the first 5 years.

If you look at their numbers, basically what they're doing is subtracting $360 billion of capital formation and saying it's out of the tax laws over a 5-year period.

And one of the things that the Wharton model didn't really take into account was the possibility of changes in capital outflows.

I think there's a substantial possibility when you move from a system where U.S. manufacturers have one of the best depreciation and capital recovery systems in the world, to a situation where they have one of the worst, I think you have to be prepared to face the substantial probability that capital investment will go elsewhere.

And if you can write off equipment in 3 years and get a 15-percent investment tax credit in Canada, you may build the next plant in Canada and not in Detroit.

I don't think any of the models necessarily have taken that into account. I don't know if there's any way you can take that into account. That's our principal concern, that with the trade balance we have——

Chairman **LaFalce**. Just as a matter of interest, we do intend to have a hearing specifically on the international competitiveness of the corporate tax code under the Treasury plan in comparison with other plans, and how that might impact it. So we will be looking at that specifically.

Mr. **Huard**. Well, I am glad to hear that because I think that probably the most important issue in this whole debate is, what is the effect of this going to be on U.S. manufacturing and do we want to have a U.S. manufacturing sector in this country 10 or 15 or 20 years down the road or do we want to sell hamburgers and life insurance to each other? I think that really is the key issue.

Chairman **LaFalce**. Others would argue, of course, that if we bring the overvalued dollar down that would be about 100 times more important than these modest changes in the Tax Code. But, that is another discussion, another day.

Mr. **Huard**. In any event, since the testimony will be in the record in full, I think I will just stop here since I did hit the major point that I wanted to make, which is that the international competitiveness aspect is crucial.

[The prepared statement of Mr. Huard on behalf of the National Association of Manufacturers [NAM] follows:]

STATEMENT OF

PAUL R. HUARD

VICE PRESIDENT, TAXATION AND FISCAL POLICY

ON BEHALF OF THE

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

ON

THE TREASURY'S TAX SIMPLIFICATION PROPOSAL

MARCH 28, 1985

I am Paul R. Huard, Vice President of Taxation and Fiscal Policy of the National Association of Manufacturers (NAM). The NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Members range in size from the very large to over 9,000 small manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 business through its Associations Council and the National Industrial Council. On behalf of our members, I am pleased to be able to present our views on the Treasury's tax reform proposal.

I. INTRODUCTION

The Treasury's recent proposal for simplification of the tax code contains both desirable and undesirable features. Its major asset is that it does achieve a considerably simpler tax system, at least for individuals. At the present time, the tax code incorporates a large number of subsidies or special provisions, all of which imply a decrease in revenues to the Federal government, the result has been that in order to make the retention of these special provisions feasible, marginal tax rates have had to be relatively high so as to offset the implicit subsidies. By doing away with large numbers of special provisions, the Treasury plan makes it possible to lower marginal rates. In this regard and in other respects also, the Treasury proposal would produce a tax code which is more neutral than the current system.

The major elements of the Treasury plan may be briefly summarized:

The plan would achieve considerable simplification on the individual side of the income tax system. For corporations, the 13 point rate reduction from the present top marginal rate of 46% would significantly alleviate the problem of excessively high effective rates of tax faced by many service sector companies as well as by some manufacturing companies. The need to provide continued incentives for technological innovation would be recognized by a three-year extension of the 25% tax credit for incremental increases in R&D expenditures, which is presently scheduled to expire at the end of 1985. Also, there is an attempt to provide relief for the double taxation of dividends. However, this may ultimately work against capital formation, as discussed in more detail below.

Nevertheless, the Treasury proposal incorporates a series of highly adverse provisions. Specifically, while lowering taxes on individuals, it raises the tax liabilities of the corporate sector. Although it lowers the maximum corporate tax rate, it eliminates targeted incentives for capital formation: the investment tax credit (ITC) and the Accelerated Cost Recovery System (ACRS) passed in 1981. The proposed new system of depreciation greatly lengthens cost recovery schedules and in this sense is a poor substitute. Total corporate tax receipts would be increased by 25% to 36% over the first five years of the Treasury plan, a cumulative increase of $165 billion. This is not only undesirable for economic reasons, it is also a direct contradiction of the claim that the tax simplification program is revenue-neutral. The overall effect of the plan on small businesses is a net minus. Areas of concern include first, the effect of substituting a flat 33% rate for the present 15%, 18% and 30% marginal rates that apply, respectively, to the first three $25,000 increments of corporate taxable income, and second, the extent to which the simplification gains achieved by the 1981 enactment of ACRS would be reversed by returning to a more complex depreciation system.

Repeal of the preferential tax rate for capital gains (which would be taxed at ordinary income rates with an adjustment for inflation) would in general raise the cost of capital.

Partial or full taxation of previously tax-free fringe benefits (*e.g.*, health and life insurance, group legal services, etc.) may pose problems for both employers and employees, especially where the labor force is unionized. Arguably, the provision of benefits deemed desirable from a societal standpoint is better done through the private sector and the tax laws should not be changed to discourage this. A similar criticism may apply to the suggested curtailments in the pension area, such as the proposed elimination of Section 401(k) plans.

The dangers involved in repeal of the targeted investment incentives (ACRS and the ITC) are readily apparent. Numerous econometric studies, which are cited in some detail below, have demonstrated a statistically significant relationship between tax incentives and capital formation. The rate of increase in business fixed investment is in turn an important determinant of productivity growth, and has favorable secondary effects on aggregate economic activity and inflation. Further, most of the other industrial countries provide favorable tax treatment of depreciation. Repeal of ACRS and the ITC would provide American firms with a substantially inferior system of depreciation than currently enjoyed by their competitors overseas. Finally, the strength of business fixed investment in 1984 corroborates the beneficial effects of the targeted incentives on the actual performance of the economy, although other factors were also involved here.

The Treasury's tax simplification proposal should not be evaluated solely on the basis of considerations of neutrality and simplicity. Instead, greater reference should be made to its probable effects on the economy, particularly its negative implications for capital formation. To this end, NAM obtained from Wharton Econometric Forecasting Associates (WEFA) a long term analysis of the Treasury plan, involving econometric simulations over a ten-year horizon. NAM's comments on the Treasury plan are based in part on this analysis. In this respect, NAM does not accept the results of a second WEFA study conducted for the Treasury, which was presented before this Committee on March 13. As documented in greater detail below, this second study incorporates several fallacious assumptions, which make its conclusions unreliable.

In Part II of this statement, the major results of the NAM-WEFA study are summarized. In Part III, a more detailed analysis of the implications for capital formation is presented. Parts IV, V and VI deal with the effects of the Treasury proposal on the sectoral mix of economic activity, federal revenues and expenditures, and aggregate economic activity respectively. The conclusions are summarized in Part VII.

II. THE WEFA ANALYSES

The First WEFA Study In order to evaluate the implications of the Treasury plan, in the first study the WEFA annual model was simulated out to 1994, incorporating the changes in the tax code proposed by the Treasury. The Treasury's tax reform is assumed to be implemented in full on January 1, 1986. The Treasury simulation was then compared with a baseline simulation of the WEFA model in which the present tax code is left intact. All the other assumptions of the forecast are the same for both simulations. The simulations reveal that the Treasury proposal has persistent effect on the economy that tends to increase over time. This finding can be taken as an indication of the potential significance of the tax proposal, particularly in view of the properties of the WEFA model. The WEFA annual model has strong cyclical and self-equilibrating properties. In other words, a policy change typically generates a short term change in the economy, which is gradually dissipated over the course of the business cycle. By comparison, the effects of the Treasury plan are permanent, and they tend to increase rather than decrease over time.

The major conclusions to emerge from the simulations are as follows:

1] The Treasury proposal reduces investment spending in virtually all categories. The user cost of capital is raised, while the after-tax rate of return on investment and real after tax profits are lowered.

2] Under the Treasury proposal, the mix of economic activity is progressively weighted toward personal consumption and away from capital formation. Real consumption expenditures increase, while spending on capital goods falls relative to the baseline.

3] The economy tends to become more labor intensive under the Treasury proposal. Because of the decrease in the after-tax rate of return on investment, business has an increased incentive to substitute into labor inputs rather than additions of new capital. The fall in the capital-labor ratio in turn results in lower productivity growth. By the same token, however, employment increases somewhat more rapidly under the Treasury plan.

4] On a sector-by-sector basis, real value-added output falls relative to the baseline in manufacturing, durable goods and capital equipment. Real output is actually somewhat higher in other areas, primarily in services and non-manufacturing sectors. The net result is that the sectoral mix of economic activity shifts away from manufacturing. In essence, the Treasury proposal produces a mild "deindustrialization" of the economy.

5] Nominal GNP is substantially higher, but mainly because of the higher inflation rate. Real GNP is only slightly higher inasmuch as the effects of lower productivity are offset by increased inputs of labor.

6] Because of lower productivity and higher employment, unit labor costs rise more rapidly under the Treasury plan, resulting in a modestly higher rate of inflation.

7] The simulation shows adverse effects on the trade balance under the Treasury plan, although the magnitudes are fairly small. Higher consumption spending causes a rise in imports, while an assumed depreciation in the dollar causes an increase in exports that offset these affects.

8] The simulation also shows both a rise in interest rates and the Federal deficit. This is due in part to the effects of higher interest rates, which raise outlays for debt service, and higher inflation, high raises expenditures on defense and indexed transfer payments.

9] The distribution of tax liabilities is shifted toward business and away from individuals. Personal tax receipts fall under the Treasury plan relative to the baseline, while corporate profits taxes increase. The plan is not revenue neutral: it raises more revenue than the present system, mainly from the corporate side.

The Second WEFA Study The results of a second WEFA study of the Treasury plan were presented in testimony before this Committee on March 13. The second study made two major changes to the assumptions used in the first. In the second study; 1] The effective corporate tax rate is assumed lowered by partial deductibility of dividends, 2] The increase in the after-tax rate of return on financial assets is assumed to lower interest rates. The results of the simulation show few major differences between the major economic aggregates under the two simulations (i.e., the original WEFA and the second study assumptions). GNP, employment, inflation, etc. are roughly the same in the long run. The user cost of capital is raised by smaller magnitudes under the Treasury assumptions. The effects on specific industries vary by sector. Capital-intensive industries are still hurt by the plan, but some industries actually do better than under current law. Of the modified assumptions used by the second study, neither appears to be entirely valid.

Dividend Deductibility This provision may or may not lower effective corporate tax rate, although it seems rather unrealistic that it could lower rates to 28%, the figure assumed in the second study. Even if effective rates were lowered, this provision would definitely not raise capital formation and in fact would tend to reduce it. In essence, it subsidizes the paying out of dividends rather than encouraging new capital formation financed through retained earnings, as is the case with ACRS and the ITC.

For this reason, the initial assumption that effective rates should be lowered is likely to bias the results. In the WEFA model, a decline in effective rates is associated with an increase in investment, which for reasons stated above is unlikely to result from the dividend deductibility provision. The allegation from the second WEFA simulation that capital formation would be higher than in the original WEFA simulation is therefore clearly incorrect.

Interest Rates The claim underlying the assumption of lower interest rates is that because taxes are lower, the rate of return on financial assets will be raised, and that financial institutions will respond by lowering interest rates. However, there is no econometric evidence linking short term movements in interest rates to changes in after-tax rates of return.

In contravention of their claim, during the 1970's when real rates of return were low and occasionally negative, both real and nominal interest rates were relatively low, by comparison wih the levels witnessed since 1980. Furthermore, the ERTA tax cuts did not produce a decline in real interest rates. At the time of the first rate cut (October 1981) real rates reached unprecedented magnitudes, as nominal rates stayed high while the inflation rate declined. The second rate reduction (July 1982) preceded a major fall in interest rates, but this took place only because the Federal Reserve shifted to a much more expansionary policy stance at this time. The third rate reduction (July 1983) coincided with rising interest rates.

Furthermore, the assumption in the second study makes implausible claims about the structure of pricing in the financial industry. If financial institutions possess discretionary authority to raise and lower interest rates based on after-tax rates of return, this implies that interest rates constitute administered prices. If so, the price structure must be oligopolistic. However, one thing that is known about administered pricing is that prices are downwardly rigid, i.e., in response to an increase in after-tax rates of return, prices will not necessarily be lowered. An alternative assumption is that interest rates are not administered prices but in fact are market determined--this is certainly closer to reality, at least as far as short term rates are concerned. In this case, fluctuations in interest rates will be determined by factors such as monetary policy and the demand for credit. Under the circumstances, a change in the after-tax rate of return will not necessarily affect interest rates at all, unless market forces independently move rates in the same direction.

In sum, there is no evidence in support of the second study's claims regarding the elasticity of interest rates to tax law. For this reason, NAM continues to regard the first WEFA study as a more reliable indication of the effects of the Treasury plan on the economy.

III. IMPLICATIONS FOR CAPITAL INVESTMENT

From the standpoint of its effects on capital formation, the most important elements of the Treasury proposal are the repeal of ACRS and the ITC. The proposal claims to compensate for this by lowering corporate tax rates across the board. However, the likely result is that this would not offset the loss of targeted investment incentives. The net outcome would be an increase in the cost of capital, a decrease in corporate liquidity and a decrease in capital investment. This would ultimately translate into lower productivity and in all likelihood reduce economic growth.

ACRS and the ITC The prognosis that the loss of ACRS and the ITC would result in diminished capital investment and liquidity is supported in several recent econometric studies. Sinai, Lin and Robins (1983) analyze the impact of the ERTA-ACRS tax package on the economy using the Data Resources U.S. Macromodel. They conclude that ERTA had beneficial effects on the economy, primarily because ACRS and other business-related measures improved corporate liquidity and raised real after-tax profits. The simulations indicate that in the absence of ERTA, real GNP would have been $24.6 billion lower during the two years following its enactment, or 1.3 percentage points. In 1982, the decline in GNP would have been -3.0% without ERTA, compared to an actual decline of -1.8%. The unemployment rate would have averaged 10.3% in 1982 rather than the 9.7% actually recorded. Forecasting over the period 1983-85, the authors conclude that without ERTA, GNP would be lower by 1.2 percentage points. Without ACRS and the business-related provisions of ERTA, real business fixed investment would have declined by two percentage points more than actually occurred.

In a more general study of the impact of tax policy on business investment, Sinai and Eckstein (1983) examine the impact of alternative types of tax changes on capital formation. They conclude that ACRS provides $0.81 in business fixed investment for every dollar of corporate tax lost, that the ITC provides $0.76 but that a corporate rate cut provides only $0.19. In other words, targeted investment incentives are found to have a considerably stronger impact on business investment than neutral tax reductions.

The ADR System The need to retain ACRS can also be evidenced by the fact that under the previous Asset Depreciation Range (ADR) system, depreciation schedules were inadequate to insure recovery of capital costs. Under ADR, depreciation deductions had to be taken over the useful life of capital equipment, typically a fairly lengthy period. As a result of the increase in inflation during the 1970s, the replacement cost of new equipment greatly exceeded the original acquisition cost. As several studies (Feldstein, 1978, 1982) have documented, ADR seriously understated real depreciation costs. Understatement of depreciation, in addition to the tendency of conventional FIFO accounting procedures to overstate inventory profits during inflationary periods, resulted in effective tax rates that were over three percentage points higher than statutory rates during the 1970s. In 1970-78, real corporate tax rates averaged in excess of over 51%, compared with the statutory rate of 48% then in effect.

The RCRS Proposal The Treasury does not propose a return to ADR but rather proposes a new "Real Cost Recovery System" (RCRS), said to approximate real economic depreciation. Under RCRS, the understatement of depreciation due to inflation under ADR would be redressed through indexation. However, in other respects RCRS lengthens depreciation schedules for most forms of capital equipment, and appears in essence to represent a return to the useful life concept employed under ADR.

The Treasury makes several claims on behalf of RCRS over ACRS, among them that RCRS is neutral across sectors; i.e., that different classes of assets face the same effective tax rates. It is also claimed that RCRS provides a lower cost of capital than under current law. On closer examination, however, both claims are revealed to be unjustified.

The argument that the RCRS proposal is neutral across sectors relies on somewhat arbitrary assumptions regarding depreciation, among them that the wearing out of equipment takes place geometrically over time and that the RCRS schedules correspond with known rates of decay. The geometric decay assumption does not match the depreciation figures used by the Commerce Department's Bureau of Economic Analysis (BEA) in order to measure the wearing out of capital equipment. Instead, BEA's assumptions are for a non-linear decay of assets. Further, the Treasury has based its assumption on single "representative" examples of equipment and structures without differentiating class lives across industrial sectors. The definition of structures as given does not correspond to structures classified as 18-year depreciable property by the IRS.

The claim that RCRS would lower the cost of capital is also unjustified, and in fact is contradicted by the Treasury's own figures. The Treasury's argument against ACRS and the ITC is predicated on the view that under certain circumstances they can result in negative rates. The RCRS proposal claims to rectify this, essentially by making all corporate rates positive. In this respect, the Treasury also predicts a cumulative increase in corporate revenues of $165 billion through 1990. Clearly, by the Treasury's own admission, RCRS results in higher tax revenues than ACRS. This cannot easily be reconciled with the Treasury's claim of a reduction in the cost of capital.

As has been pointed out in other sources, the Treasury's argument that it would lower the effective tax rate fails to take into account the broadening of the base. While the proposal would lower corporate rates by 28%, it broadens the business tax base by 170%. This enlarged tax base is then used as the denominator in computing the effective tax rate. The allegation of a lower tax rate on capital is therefore nothing more than a spurious result of a base broadening process which raises the tax on capital by 20% to 25%.

When the effect of the RCRS depreciation schedules is recalculated using different depreciation assumptions and taking other direct and indirect taxes into account, the conclusion is that RCRS results in higher effective tax rates. Moreover, there is little evidence that the RCRS schedules approximate the real economic depreciation of capital equipment.

The need to retain the investment incentives deleted by the Treasury proposal is also underscored by the fact that several elements of the current economic environment tend to work against capital formation. Paramount in this respect are high interest rates, depressed business liquidity and uncertainty about the future course of the economy. Targeted investment incentives provide a means of partially offsetting these factors. In this respect, it should be noted that as a result of ACRS, the U.S. underwent a major boom in business investment in 1983-84. In 1984, real spending on new capital equipment is expected to post an unusually strong gain of approximately 14%. This expanded investment in the face of the previously-mentioned adverse environmental factors is indicative of the favorable impact of ACRS.

One argument that the Treasury has alleged in defense of its proposal is that it would raise the "quality" of investment. In other words, by eliminating tax shelters, investment would be channelled away from unproductive activities that have high after-tax rates of return, and into more productive ventures where decisions to invest are based on considerations other than tax reduction. The Treasury plan would in this respect clearly eliminate many abusive tax shelters. However, in other respects it is difficult to find any evidence that the plan would have any qualitative impact on investment. Because of the increase in corporate tax liabilities, the decrease in the after-tax rate of return and higher interest rates, the volume of capital investment falls relative to the baseline in the NAM-WEFA study. Since this implies a decrease in spending to replace worn-out equipment, it follows that the quality of the capital stock would deteriorate.

Other Elements of the Treasury Plan In the area of capital gains, the implications of the Treasury proposal are ambiguous. The deductibility of dividends paid out to corporate shareholders is presumably aimed at mitigating the double taxation of such dividends. However, this may be more than outweighed by the ending of the preferential treatment of capital gains. While deductibility of dividends is billed as likely to raise capital investment, this is at best a dubious proposition. In reality it could have the opposite effect; i.e., it should work against capital formation. It would give corporations an incentive to pay out profits to stockholders rather than plow profits back into new investment.

The overall effect of the plan on small business is unclear. Small corporations will face a major increase in taxation, even disregarding the repeal of the ITC and ACRS writeoffs. Small corporations under present law pay marginal tax rates of 15%, 18%, and 30% on the first three $25,000 increments of corporate taxable income; under the Treasury plan their taxes on this income would be raised to the flat 33% rate. However, personal proprietorships and Subchapter S corporations might benefit inasmuch as marginal personal tax rates would be lowered. Nevertheless, when the losses of other deductions are taken into account, this benefit could easily be outweighed.

The Simulation Results The first WEFA study confirms that the Treasury tax proposal has substantial adverse long term effects on investment. In 1994, gross private domestic investment in constant 1972 dollars is $15.0 billion or 3.9% lower than in the baseline. Gross fixed investment shows a differential of $15.1 billion or 4.1% in 1994. Non-residential investment shows a differential of $15.0 billion or 5.0% in 1994.

Essentially the same prognosis applies to the capital stock. In real terms, the capital stock is lower in agriculture, mining, durable goods, construction materials, primary and fabricated metals, electrical and non-electrical machinery, autos, and most of the light industries: textiles, clothing paper, printing, chemicals, transportation, communication and utilities.

Because of the decrease in the after-tax rate of return on investment, the Treasury plan effectively raises the user cost of capital. In the WEFA model, the user cost of capital is defined as a weighted combination of the interest rate for particular industries (normally the corporate bond rate), the depreciation rate, the effective corporate tax rate including the investment tax credit, and the tax life of industry assets. The user cost of capital is therefore raised primarily by the loss of ACRS and the ITC, and secondarily by the rise in interest rates.

This effect is not limited to capital-intensive sectors, but takes place throughout the economy. By 1994, the user cost of capital averages 25% to 30% higher under the Treasury plan than in the baseline.

IV. EFFECTS ON THE SECTORAL MIX OF ECONOMIC ACTIVITY

The rhetoric used to justify the Treasury proposal makes numerous reference to supply-side economics. The proposal, so it is asserted, would raise personal incentives for saving and labor force participation, and indirectly raise growth rates. But no evidence is provided to support this contention. As has been pointed out with respect to most of the current "flat tax" proposals (for instance in Prakken, Meyer and Varvares, 1984), the alleged improvement in work and savings incentives for individuals is more than offset by the increase in taxation on capital, with the result that such proposals must be viewed as more likely to depress the growth rate in the long run.

The Prakken, Meyer and Varvares (1984) study examines both the Bradley-Gephardt FAIR and Kemp-Kasten FAST tax proposals of the 98th Congress (1982-1984). It concludes that the repeal of ACRS and the other business-related ERTA provisions would raise the cost of capital, lower real after tax corporate profits and lower investment spending. The study concludes that the various tax simplification proposals studied share a common drawback: they tend to raise taxes on capital in order to lower taxes on individuals. The net effect is to raise consumption while lowering investment.

The relative merits of lowering marginal personal tax rates can only be assessed through an analysis of the multipliers on savings and labor force participation. Any number of studies have recently been conducted on the relationship between marginal tax rates and personal behavior with respect to alleged savings-consumption and work-leisure tradeoffs. Boskin (1978) and Evans (1981) both claim a positive relationship between tax rate cuts for individuals and savings, but this is disputed in other studies (Howrey and Hymans, 1978; Pechman, 1983; Penner, 1983). Circumstantial evidence from ERTA also does not support the view that marginal personal tax rates are a major determinant of savings behavior. Irrespective of what savings incentives the 25% reduction in marginal personal rates may have provided, factors such as the demographic composition of the workforce have caused the savings rate to decline since 1981. A detailed analysis of the effects on work incentives is presented by Hammermesh (1981). The conclusion is that the progressivity of the tax system does not appear to have substantially affected employment. Eckstein (1980) finds a relationship between tax policy and labor force participation, but the magnitude is exceedingly small.

The weak and largely unsubstantiated relationships between personal tax rates, saving and work incentives stand in striking contrast to strong, statistically significant and well-documented relationships between tax treatment of investment and business capital formation. The classic work here is Hall and Jorgenson (1967). In addition to the studies cited earlier, representative examples include Henderschott (1981) and Maloney (1983).

Mechanisms such as ACRS and the ITC have been found to raise business investment by substantial magnitudes.

The upshot is that under the Treasury plan successful business investment incentives would be sacrificed in favor of the nebulous and ephemeral possibility of altering individual work and saving behavior.

Results of the Simulations The first WEFA simulation suggests that on the whole the effects of the Treasury proposal on the mix of economic activity is to stimulate consumption, while at the same time engendering some increases in labor force participation. The final outcome is higher employment, with higher wages due to greater tightness in labor markets, lower productivity, and a shift in factor income shares in favor of personal income.

The labor force grows slightly more rapidly under the Treasury plan. Nevertheless, the labor force participation rate is essentially the same under both simulations. Employment is slightly higher under the Treasury plan. The failure of the labor force participation rate to increase, however, suggests that the alleged effects of the tax cuts on work incentives are not the factor responsible for higher growth in the workforce. Instead, the Treasury plan appears to raise employment through the somewhat perverse channel of reducing demand for investment goods. Because of the decrease in the after-tax rate of return on investment, business substitutes into additional inputs of labor rather than undertaking new capital investment. The result is that demand for labor is raised, yielding higher employment.

The increase in employment has two effects that tend to raise the rate of inflation. First, because labor markets are tighter, wages rise more rapidly. Simultaneously, productivity is lowered, primarily because of higher inputs of labor relative to capital. The net result is that the inflation rate is also higher under the Treasury plan. By 1994, the GNP Deflator is rising 1.9% more rapidly under the Treasury plan than under current law. The higher inflation rate in turn implies higher nominal interest rates. Interest rates rise cumulatively in the Treasury simulation relative to the baseline, and by 1994 corporate bond rates are 1.4 points higher while three-month Treasuries are higher by 1.81 points. However, it should be noted in this context that the prognosis of higher interest rates is dependent on the assumption of higher inflation.

The simulations clearly demonstrate that the effect of the proposal is to raise consumption expenditures. In essence, the Treasury plan shifts the mix of aggregate economic activity in favor of consumption and away from investment. In essence, whatever the plan's ostensible objectives vis-a-vis the structure of incentives, the net outcome is to raise consumption at the expense of investment. The sectoral mix of economic activity is shifted in favor of greater spending; the investment share of GNP declines in order to pay for increased consumption.

V. FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES

Ostensibly, the Treasury plan is revenue-neutral, i.e., it changes the tax structure while leaving the amount of revenue raised essentially intact. On closer examination, however, it is revealed that because of the ancillary effects of tax reform on the economy, significant differences emerge between the trajectories of revenues and expenditures between the Treasury proposal and the baseline.

The Treasury plan actually raises more revenue, for a series of reasons. Although employment is higher, this is offset by the decline in personal tax liabilities. Instead, the major revenue gains are derived from the corporate profits tax and other indirect business taxes. In the first WEFA study, by 1994, personal tax receipts are $37.7 billion lower under the Treasury proposal, notwithstanding the higher number of persons employed. However, corporate profits taxes are $60.5 billion higher. Indirect business taxes are higher by $1.3 billion. The other area in which the Federal government gains revenue is in social security contributions. Total Federal revenues are raised by $40.9 billion, or 2.5%.

Simultaneously, however, Federal expenditures are also raised by the higher rate of inflation that occurs under the Treasury proposal. Furthermore, because of higher interest rates, the government spends more on debt service. The major area in which the government is able to save money is in unemployment insurance benefits, which are lowered by $4.5 billion.

Since the rise in spending is greater than the corresponding rise in revenues, the Federal deficit is also somewhat higher under the Treasury proposal. The Federal deficit rises in the Treasury simulation relative to the baseline, starting in 1990. By 1994, the Federal deficit is $419.2 billion under the Treasury plan, compared to $400.8 billion with current law in effect, a difference of $18.4 billion.

In sum, there appears to be little justification for the claim that the impact of the Treasury proposal on Federal finances is neutral. The Treasury proposal tends to raise revenues, outlays and the deficit; further, it shifts the composition of Federal revenues away from personal tax receipts and in favor of corporate profits taxes, indirect business taxes, and social insurance contributions.

VI. AGGREGATE ECONOMIC ACTIVITY AND THE EXTERNAL SECTOR

The effects of the Treasury proposal on real output vary by sector. Aggregate economic activity is somewhat higher. However, output by sector varies considerably, depending on the industry-specific implications of the reform plan.

In the first WEFA study, nominal GNP is higher by $159 billion under the Treasury proposal. Most of this increase is simply due to inflation. In constant 1972 dollars, real GNP is higher by only 0.2% by 1994, a statistically insignificant magnitude.

Capital-intensive sectors and manufacturing, however, experience slower growth. Relative to the baseline, manufacturing shows a decline of $3.3 billion, while durable goods are lower by $5.1 billion. In essence, the economy becomes more service-oriented under the Treasury proposal, while manufacturing industries undergo smaller increases in output than they would with current tax laws in effect.

The Treasury plan appears on theoretical grounds to have adverse effects on international competitiveness. The model simulations reveal an essentially negative impact on the trade sector, although the reasons have more to do with changes in demand and fluctuations in the value of the dollar. The magnitudes, however, are exceedingly small, and the conclusion that emerges from the simulations is that the Treasury plan would have only minimal effects on the external sector.

In a theoretical sense, the Treasury plan reduces competitiveness through the channels of decreased productivity, increases in the price level and increases in the user cost of capital. All of these factors, however, can be offset by devaluations of the dollar, with the result that the net effect on exports is small, and requires considerable time before it becomes visible. A stronger effect is recorded on imports. Because the Treasury plan raises consumer demand while reducing the productive efficiency of the economy and therefore the ability of domestic producers to satisfy this demand, the result is a rise in imports.

The first WEFA study, however, does not take into consideration possible losses in competitiveness due to changes in the American tax code relative to tax provisions abroad. This is particularly manifest in the area of depreciation laws. Under ACRS, the United States has enjoyed depreciation schedules that are on the whole somewhat better than in the other industrial countries, although still inferior to Canada, Sweden and the United Kingdom (prior to 1984 when depreciation provisions were reduced). Under RCRS, however, depreciation schedules in the United States would be substantially longer than in most of the other advanced economies, and inferior to those in any number of middle income developing countries.

The effect of this differential in depreciation laws could induce American firms to move overseas in order to take advantage of more favorable depreciation allowances. In essence, multinational corporations would have an increased incentive to build new plant in foreign countries because of the more favorable tax treatment of capital investment. The finished products would then be exported to the United States. The net effect would be that the American economy would lose both new capital investment and jobs at the same time as the trade balance deteriorated. The likelihood of this taking place is further heightened by the overvaluation of the dollar. The high value of the dollar makes it easier to transfer liquid capital abroad in order to construct new plants, and facilitates exporting to the United States from foreign countries.

Finally, it should be noted that the danger of "off-sourcing" is heightened by the fact that Canada has very liberal depreciation laws. In Canada, 50% of the value of capital acquisitions can be written off in the first taxable year, and the remainder can be written off by the second. Furthermore, capital spending is eligible for an investment tax credit with rates ranging from 7% to 20%. Assuming that the 7% rate applies, as is the case for most categories of capital equipment, Canada permits 108% of the acquisition cost to be written off in two years. This is actually superior to ACRS and the ITC in the United States, and would be considerably better than the Treasury's RCRS proposal. The proximity of Canada to the United States and the favorable position of the new Conservative government to foreign investment would both make it relatively easy for American firms to relocate new plant to this country. In the final analysis, therefore, the effects of the Treasury plan on the trade deficit could very well be more adverse than predicted by the WEFA model.

VII. CONCLUSIONS

The effects of the treasury proposal on the long term trajectory of the economy are ambivalent at best and at worst highly unfavorable. The economy experiences slightly higher total output, employment, and production in non-capital-intensive sectors. However, this is achieved only at the expense of slower growth in capital-intensive manufacturing industries and markedly smaller gains in investment. The mix of output is shifted in favor of personal consumption expenditures and away from capital formation. In essence, the country undergoes slower growth in the the capital sector in order to pay for increases in consumption. At the same time, changes in the output mix, productivity and capital formation imply a series of indirect effects, among them a higher inflation rate, which contributes to a rise in Federal expenditure and higher interest rates. The distributuion of tax liabilities is shifted toward the business sector: of the increased revenue achieved under the proposal, the bulk is derived from the corporate profits taxes, which more than offsets a decline in personal tax receipts. In this sense, the final impact on the economy is on balance unfavorable to business. While certain sectors would benefit from greater neutrality in the tax code and lower tax rates, manufacturing industry, aggregate corporate tax liabilities and capital formation would be affected adversely in the long run.

The complete failure of the Treasury proposal in the area of capital formation in turn underscores the need to retain targeted investment incentives such as ACRS and the ITC. A tax simplification proposal which preserves specific incentives for capital formation would be able to achieve the highly desirable goal of greater neutrality without penalizing capital formation.

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Chairman **LaFalce**. Thank you.

We will now hear from the chief economist for the Urban Institute, Charles R. Hulten.

STATEMENT OF CHARLES R. HULTEN, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

Mr. **Hulten**. Unfortunately, I am not the chief economist, but——

Chairman **LaFalce**. Well, you should be.

Mr. **Hulten**. I am aspiring to that role, so——

Chairman **LaFalce**. I mean I don't know the chief economist, but—if I knew the chief economist I might change my mind, but, OK.

Mr. **Hulten**. Mr. Chairman, I appreciate this opportunity to testify on the sectoral consequences of the Treasury proposals.

Since others have testified on the general features of the Treasury plan, I will direct my remarks to the more specific issue of capital cost recovery.

The proposed revision of depreciation policy is, in my view, the centerpiece of the Treasury's business tax proposals. It is therefore a primary determinant of the industrial impacts of the overall plan.

The Treasury depreciation proposal represents a significant improvement on the accelerated cost recovery system [ACRS]. It provides badly needed flexibility and removes much of the arbitrariness that has made ACRS politically vulnerable—so vulnerable, in fact, that it has been revised twice in its 4-year life.

To illustrate the inflexibility of ACRS, consider this: Most types of equipment are grouped into a single class and assigned a 5-year writeoff period. This means that rapidly obsolescing equipment like computers are treated the same way as relatively long-lived assets like ships. The true depreciation cost of using computers is usually much larger. The failure of ACRS tax writeoffs to recognize this fact conveys, other things equal, a relative disadvantage to investment in computers.

The Treasury proposal adds flexibility to the ACRS 5-year class by breaking it into four parts and assigning the parts to each according to their true depreciation cost. I have provided a table 1 with my comments to illustrate the breakup of ACRS into the more flexible class system. I think it is important not to focus too much on the novelty of the Treasury proposal and to recognize its relation to ACRS. As I see it, the Treasury plan provides a more articulated, more fine-grained, approach to providing a class structure for depreciation.

Statistical studies of true economic depreciation provide the criterion for the new groupings and new rates of depreciation. The Treasury depreciation numbers initially are based on research that I did with Prof. Frank Wykoff of Pomona College. Thus, where ACRS provides truly arbitrary depreciation periods, the Treasury rates are based on data on how capital actually depreciates.

How do you measure this actual depreciation? You let the market do it for you. Many types of buildings and equipment have active resale markets. Office buildings, warehouses, industrial structures, stores, machine tools, construction equipment, and autos, are some of the more prominent examples.

By observing how the average inflation-corrected market price declines with the age of the asset, you obtain an estimate of how an asset depreciates as it grows older and is used up in production.

Actual depreciation measured in this way will, in general, vary from asset to asset. Therefore, any system which simplifies compliance by grouping assets can only hope to approximate true depreciation.

The smaller the number of classes, the simpler but less accurate is the system. The Treasury classes strike a balance between simplicity and accuracy by grouping broad classes of assets with similar rates of depreciation.

By attempting to align tax and economic depreciation and by abolishing the investment tax credit, the Treasury proposal seeks to level the playing field for all types of tangible capital. Since the economic income earned by different assets is not eroded for tax purposes by accelerated deductions and credits, the same statutory tax rate applied to all assets yields approximately the same effective rate on all assets.

The Treasury proposal also levels the playing field with respect to inflation. Under current law, a business can only depreciate the original purchase price of the capital good. If inflation causes the replacement cost of the asset to rise, the owner loses. The real value of depreciation deductions fall and the effective tax rate rises. If inflation gets bad enough, Congress may further accelerate depreciation allowances as an offset to the rising effective tax rate. This is essentially what happened in 1981 with the adoption of ACRS.

The problem with this way of dealing with inflation is that Congress is often slow to act and has shown an inclination to decelerate depreciation when inflation slows. A more direct and politically certain solution to the inflation problem is to move to replacement cost depreciation. The Treasury proposal does this by annually indexing the depreciable basis of each asset.

The benefits of a level playing field are not universally applauded. The possible loss of ACRS tax benefits and the investment tax credit has led some to argue that the Treasury plan harms the prospects for continued economic growth. However, this concern should be tempered by the recognition that the loss of these benefits is offset by other gains: reduction in the top statutory corporate tax rate from 46 to 33 percent, the dividend relief provided for and the indexing of depreciation allowances.

Treasury revenue estimates for the years 1986 through 1990 show that the net affect of all these provisions on corporate tax liabilities is negligible. This may seem surprising in light of the highly publicized increase in corporate taxes proposed by the Treasury.

I have provided a table 2 with my remarks that give some indication of the magnitudes involved. I have added up the revenue estimates in the back of Treasury volume 1, and found that the general provisions relating to the taxation of capital income are basically a wash for the first 5 years.

I would add that this picture might change quite a bit in the second 5 years because of the fact that in switching away from ACRS to a less accelerated depreciation system, there is a once-and-for-all revenue change. So the numbers beyond 1990 might look quite different and actually show the Treasury plan to some advantage. I don't know what these numbers are; the Treasury did not publish them.

This table indicates that almost all of the $165 billion of total corporate tax increases are located in three sectors—energy, finance, and construction. This touches on some of the concerns about the impact of the Treasury plan on the manufacturing sector.

The mutual offsetting nature of the general provisions are reflected in the effective tax rates that I have presented in table 3. I have shown in that table the results of three studies—my own, the Treasury study, and a study by Jane Gravelle.

The tax rates refer to the corporate business sector as a whole and to an equity financed investment.

The mutually offsetting nature of the general provisions shows up in these estimates. In fact, the overall change in effective tax rates implies a small positive impact on the demand for capital.

It is also evident that this result varies by type of equipment and that the impact on equipment is negative. This means that the tax burden on some equipment-intensive firms might rise. This may hurt some manufacturing industries, but estimates prepared by Treasury and by Jane Gravelle suggest that the manufacturing sector as a whole is not singled out for especially harsh treatment.

Tax burdens will also depend on the propensity to pay out profits as dividends. Other things equal, companies with a higher payout ratio will experience a tax decrease and those with low ratios will face rising effective tax rates.

The impact of the Treasury plan will thus vary from company to company. This is an unavoidable consequence of leveling the playing fields without lowering the average level of that field by cutting taxes. But while some companies and industries may lose, it seems clearly unwarranted to conclude that the Treasury plan is definitely antigrowth.

It is, however, fair to conclude that the Treasury proposals restore the fundamental principle that taxes should finance the cost of Government in a fair and simple way with minimum distortion of economic choices.

Thank you.

[The prepared statement of Mr. Hulten follows:]

Prepared Statement

of

Charles R. Hulten

Senior Research Associate, The Urban Institute

before the

Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

March 28, 1985

Mr. Chairman and members of the Committee, I appreciate this opportunity to testify on the sectoral consequences of the Treasury tax reform proposals. Since others have testified on the general features of the Treasury plan, I will direct my remarks to the more specific issue of capital cost recovery. The proposed revision of depreciation policy is, in my view, the centerpiece of the Treasury's business tax proposals; it is therefore a primary determinant of the industrial impacts of the overall plan.

The Treasury depreciation proposal represents a significant improvement on the existing Accelerated Cost Recovery System. It provides badly needed flexibility, and removes the arbitrariness that has made ACRS politically vulnerable- so vulnerable, in fact, that it has been revised twice in its four year life.

To illustrate the inflexibility of ACRS, consider this: most types of equipment are grouped into a single class and assigned a five year write-off period. This means that rapidly obsolescing equipment like computers are treated the same as relatively long-lived assets like ships. The true depreciation cost of using computers is usually much larger, and the failure of ACRS tax write-offs to recognize this fact conveys (other things equal) a relative tax disadvantage to investment in computers.

The Treasury proposal adds flexibility to the ACRS 5 Year Class by breaking it into four parts, and assigning assets to each part according to their true depreciation cost. Computers and other rapidly depreciating equipment are placed in a separate class with a depreciation rate of 24%, ("RCRS" Class 2 in accompanying Table 1), while more slowly depreciating types of equipment are assigned to classes with depreciation rates of 18%, 12% and 8% (RCRS 3, 4, or 5). Other ACRS assignments remain almost intact, albeit with a new depreciation rate: the ACRS 3 Year Class becomes Treasury Class 1 (32%), the ACRS 18 Year Class becomes Class 7 (3%), and the ACRS 10 and 15 Year Classes are combined into Class 6 (5%).

Statistical studies of true, or "economic," depreciation provide the criterion for the new Treasury groupings, and are the basis for the tax depreciation rate assigned to each of the new classes. Thus, where ACRS provides purely arbitrary and very generous depreciation periods - the so-called "10-5-3" system - the Treasury class rates are based on data on how capital actually depreciates over time.

How do you measure this actual depreciation? You let the market do it for you. Many types of buildings and equipment have active resale markets: office buildings, warehouses, industrial structures, stores, machine tools, construction equipment, and autos to name some of the more prominent examples. By observing how the average inflation-corrected market price declines with asset age, you obtain an estimate of how an asset depreciates as it grows older and is used up in production.

Actual depreciation measured in this way will, in general, vary from asset to asset. Therefore, any system which simplifies compliance by grouping assets can only hope to approximate economic depreciation. The smaller the number of classes, the simplier but less accurate is the system. The Treasury classes strike a balance between simplicity and accuracy by grouping broad classes of assets with similar rates of economic depreciation.

By attempting to align tax and economic depreciation and abolishing the investment tax credit, the Treasury proposal seeks to level the playing field for all types of tangible capital. Since the economic income earned by different assets is not eroded for tax purposes by accelerated deductions and credits, the same statutory tax rate applied to all assets yields approximately the same effective tax rate on all assets.

The Treasury proposal also levels the playing field with respect to inflation. Under current law, a business can only depreciate the original purchase price of the capital good. If inflation causes the replacement cost of the asset to rise, the owner loses. The real value of depreciation deductions fall, and the effective tax rate rises. If inflation gets bad enough, Congress may further accelerate depreciation allowances as an offset to the rising effective tax rate. This is essentially what happened in 1981 with the adoption of the ACRS.

The problem with this way of dealing with inflation is that Congress is often slow to act, and has shown an inclination to decelerate depreciation when inflation slows. A more direct and politically certain solution to the inflation problem is to move to replacement cost depreciation. The Treasury proposal does this by annually indexing the depreciable basis of each asset.

Industrial and Sectoral Impacts

The benefits of a level playing field are not universally applauded. The possible loss of ACRS tax benefits and the investment tax credit has led some to argue that the Treasury plan harms the prospects for continued economic growth. However, this concern should be tempered by the recognition that the loss of these benefits is offset by other gains: the reduction in the top statutory corporate tax rate from 46 to 33 percent; the deduction for one-half of dividends paid; and the indexing of depreciation deductions. Treasury revenue estimates for the years 1986-90 show that the net effect of all these provisions on corporate tax liabilities is negligible.

This may seem surprising in light of the highly publicized increase in corporate taxes proposed by the Treasury. However, this increase is almost entirely due to special industry provisions that primarily affect the energy, finance, and construction sectors. With the broadening of the tax base implied by these special provisions, the loss of ACRS depreciation and the investment tax credit is almost exactly offset by the other general features of the Treasury plan.

The mutually offsetting nature of the general provisions is reflected in the effective tax rates shown in Table 3. These estimates indicate that the overall impact of the Treasury plan on the demand for capital is positive. However, it is also evident that the impact on equipment investment is negative, implying that the tax burden on some equipment-intensive firms may rise. This may hurt some manufacturing industries, but estimates prepared by the Treasury and by Jane Gravelle of the Congressional Research Service suggest that the manufacturing sector as a whole is not singled out for especially harsh treatment.

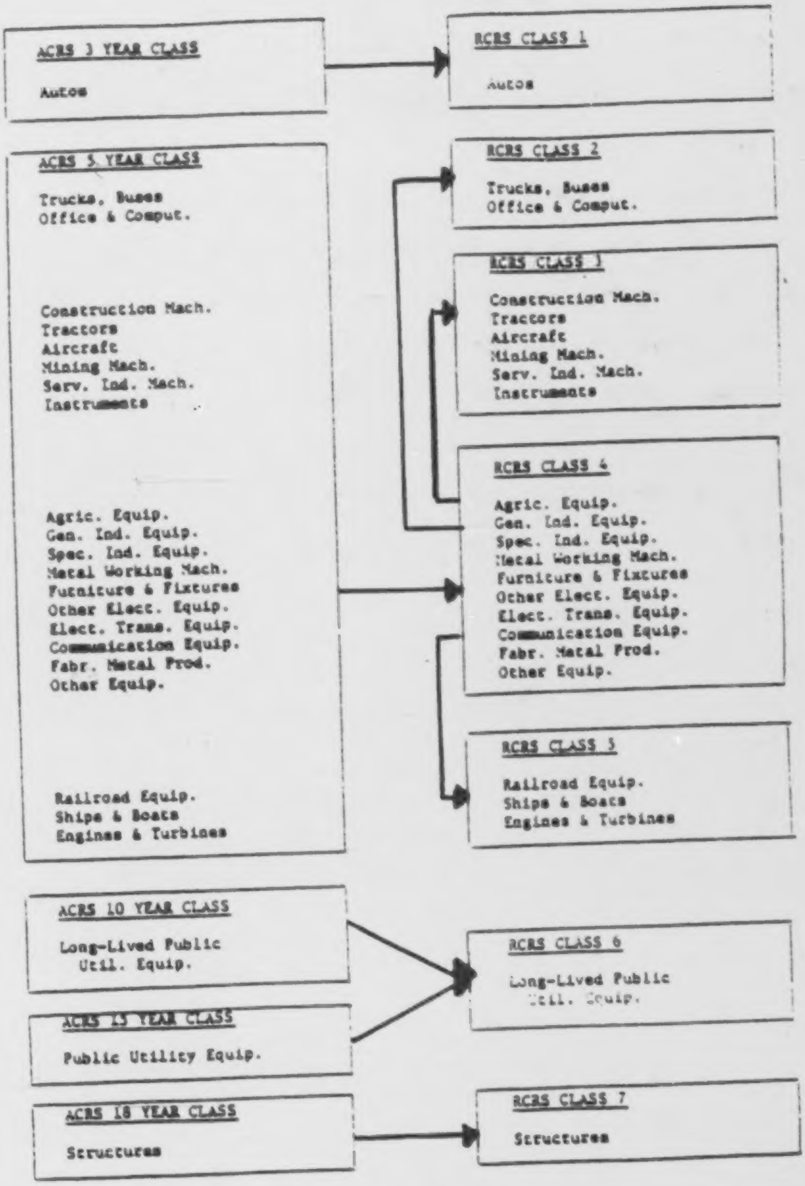
Tax burdens will also depend on the propensity to pay out profits as dividends. Other things equal, companies with a high payout ratio will experience a tax decrease, and those with low ratios will face rising effective tax rates.

The impact of the Treasury plan thus will vary from company to company. This is an unavoidable consequence of leveling the playing field without lowering the average level of the field by cutting taxes. But, while some companies and industries may lose, it seems unwarranted to conclude that the overall impact of the Treasury plan is antigrowth.

It is, however, fair to conclude that Treasury proposals restore the fundamental principle that taxes should finance the cost of government in a fair and simple way, with minimum distortion of economic choices.

Table 1

COMPARISON OF DEPRECIATION ALLOWANCES
UNDER ACRS AND RCRS


ACRS 3 YEAR CLASS
Autos
RCRS CLASS 1
Autos
ACRS 5 YEAR CLASS
Trucks, Busses
Office & Comput.
Construction Mach.
Tractors
Aircraft
Mining Mach.
Serv. Ind. Mach.
Instruments
Agric. Equip.
Gen. Ind. Equip.
Spec. Ind. Equip.
Metal Working Mach.
Furniture & Fixtures
Other Elect. Equip.
Elect. Trans. Equip.
Communication Equip.
Fabr. Metal Prod.
Other Equip.
Railroad Equip.
Ships & Boats
Engines & Turbines
RCRS CLASS 2
Trucks, Busses
Office & Comput.
RCRS CLASS 3
Construction Mach.
Tractors
Aircraft
Mining Mach.
Serv. Ind. Mach.
Instruments
RCRS CLASS 4
Agric. Equip.
Gen. Ind. Equip.
Spec. Ind. Equip.
Metal Working Mach.
Furniture & Fixtures
Other Elect. Equip.
Elect. Trans. Equip.
Communication Equip.
Fabr. Metal Prod.
Other Equip.
RCRS CLASS 5
Railroad Equip.
Ships & Boats
Engines & Turbines
ACRS 10 YEAR CLASS
Long-Lived Public
Util. Equip.
ACRS 15 YEAR CLASS
Public Utility Equip.
RCRS CLASS 6
Long-Lived Public
Util. Equip.
ACRS 18 YEAR CLASS
Structures
RCRS CLASS 7
Structures

Source: Charles R. Hulten, The Treasury Tax Proposal and The Prospects for Long-Run Growth, Table 5.

Table 2

TREASURY ESTIMATES OF CORPORATE TAX REVENUE CHANGES DUE TO VARIOUS PROVISIONS OF TREASURY PROPOSAL*

	TREASURY REVENUE ESTIMATES 1986-1990
Basic Taxation of Capital Income	
Max Corp Rate 33%	-203778
Economic Depr.	180485
Repeal ITC	123904
Dividend Relief	-97702
SUBTOTAL	2909
Other Basic Prov.	-5109
TOTAL	-2200
Industry Specific Tax Changes	
Energy	33498
Financial Instit.	54836
Construction (Time Value of Money)	41516
SUBTOTAL	129850
Other Specific Ind.	32514
TOTAL	162364
Other Provisions Affecting Corps.	4705
Total Corporate Tax Changes	164869

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*Tax Reform for Fairness, Simplicity and Economic Growth (Treasury Proposal), volume 1, pages 245-254.

Table 3

Comparison of Total Effective Tax Rates from Various Recent Studies[1]
(percentages)

	Producer's Durable Equipment	Nonresidential Structures	Inventory	Total
Current Law				
Hulten[2]	29	56	64	52
Treasury[3]	26	56	61	53
Gravelle[4]	14	39	60	41
Treasury Proposal				
Hulten	47	48	49	48
Treasury	44	44	44	44
Gravelle	39	39	41	39

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[1] Studies differ as to assumptions about inflation and discount rates, as well as in weights assigned to different types of assets.

[2] The Treasury Tax Proposal and The Prospects for Long-Run Growth, Table 4 with 50% dividends and 50% capital gains, 4% inflation and a 3% real discount rate.

[3] Tax Reform for Fairness, Simplicity, and Economic Growth, Table 6-4 with 5% inflation and 4% real after-tax corporate discount rate.

[4] Jane Gravelle, A Comparative Analysis of Five Tax Proposals: Effects of Business Income Tax Provision, Congressional Research Service 84-832 E, December 1984. Table 3; assumes 5% inflation and 7% real before-tax return to individuals.

Chairman **LaFalce**. Thank you very much, Mr. Hulten.

I am not going to ask you questions. I just want to make sure I understand what you are saying.

Basically, you are contradicting what Mr. Huard of NAM said, when he was talking about a decrease in capital investment coming about, therefore, a decrease in productivity and economic growth. You were suggesting that productivity and economic growth are comprised of more than capital investment and, therefore, this plan would either be neutral or increase it. Is that a fair representation of your position?

Mr. **Hulten**. Yes, but I think it is probably useful to point out that people mean different things when they talk about capital. Some people mean business fixed investment.

One of the contributions of the Treasury proposal is the reminder that inventory investment is also capital. It is the inventory investment category which is mainly responsible for the favorable, overall impact on capital formation.

Chairman **LaFalce**. When we get to the question and answer period we are going to have to find out what Mr. Huard and Mr. Brinner were talking about when they defined fixed assets. We will come back to that.

We also want to get their opinion on AEI's testimony. A week or so ago, AEI said when you factor in not just fixed assets but all capital including inventory, the other impact you would have is an increase in GNP under this plan. And it's a rather important position for you people to agree with.

But, in any event—we have been saving the best for last—and that is Miss Jane Gravelle, economist for the Congressional Research Service, who has her own particular point of view on this issue. I now want to publicly thank Miss Gravelle for the assistance she gave this subcommittee when last September we embarked on our study of the corporate tax code as industrial policy, and we quoted her study liberally in that report that we issued in December.

Miss Gravelle.

STATEMENT OF DR. JANE G. GRAVELLE, ECONOMIST, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Ms. **Gravelle**. I would like to thank you for the invitation to appear before you today to discuss the issue of differential effective tax rates by asset and industry.

My discussion will address not only the presence, causes, and consequences of these tax rates but also the effects of a number of tax proposals on differential tax rates.

Current tax law is characterized by substantial variation in effective tax rates by asset type. In the case of depreciable assets and inventories, which I will consider here, which constitute most of the reproduceable stock of business capital in the United States, these tax rate differentials arise from three basic tax provisions.

The investment tax credit, which is restricted to equipment and certain types of structures, reduces the tax rate on these eligible assets by allowing a credit for part of the cost of purchasing the asset. Furthermore, even if the investment tax credit were allowed on all assets, it would favor short-lived assets over long-lived assets.

The second major tax provision is the use of historical acquisition cost to figure depreciation or cost of goods sold under certain inventory accounting methods, such as first-in, first-out, or FIFO.

The use of historical cost basis penalizes short-lived assets more than long-lived ones, and its effects thus offset some effects of the investment tax credit. Inflation penalties are, however, largest in the case of FIFO inventories.

The third type of tax provision is accelerated depreciation, which allows costs to be recovered at a rate faster than the true economic decline of the asset. Accelerated depreciation favors depreciable assets, and its favoritism among short- and long-lived assets depends on its exact forms.

These types of distortions are not new to the Tax Code. The investment credit was first introduced in 1962. Inflation has been present at varying rates for many years. The depreciation rules have been changed in a number of ways, but the current depreciation rules are clearly designed to recover depreciation over periods that average much shorter than estimated service lives.

The consequences of tax differentials are straightforward. In the absence of some type of market failure, private markets will allocate resources in the most efficient manner. When tax burdens differ by asset type, there are two types of distortionary effects, if you assume these tax differentials are not actually addressing some market failure.

First, businesses will use an inefficient mix of assets in their production, and, second, capital will be allocated across industries in the wrong amounts, and the relative prices of products will not reflect their true resource costs.

The effect of the tax system on different assets depends on the interaction of the effects of investment credits, historical cost basis, and accelerated depreciation. The method of capturing these effects in a single measure for comparison is to measure the effective tax rate on new investment. This sort of measure captures the permanent effects of the tax system.

The technique used is to compare what rate of return a given project would earn if there were no tax payments or benefits—this is the pretax return—with the return it actually earns with the payment of tax and the receipt of benefits, or the after-tax return.

This notion really isn't all that complicated. For example, if you find that the pretax return on investment is 10 percent and the after-tax return is 5 percent, then the effective tax rate is 50 percent. Out of the pretax return of 10 percent, you paid half of the return in taxes, leaving you 5 percent after tax.

If the pretax return and the after-tax return are the same—5 percent—then the effective tax rate is zero.

It is possible for the tax rate to become negative when tax subsidies are large enough, and this negative tax rate would simply mean that the value of tax credits and deductions is greater than the value of tax payments.

One can measure, using this approach, the corporate tax rate or a combination of corporate and personal tax rates. The latter will be higher.

The measure that best facilitates comparison among different proposals is to measure the total tax burden, which includes both corporate and personal taxes.

In a recent study I prepared, entitled "A Comparative Analysis of Five Tax Proposals: Estimates of Business Income Tax Provisions," estimates of these effective tax rates were prepared for current law and for a number of tax proposals.

Under current law, I estimated that the effective tax burden on equipment was 14 percent, the effective tax burden on structures was 39 percent, and the effective tax burden on inventories was 60 percent. The weighted average tax rate was 41 percent. And these are general aggregates, but there was additional variation within each class of assets.

The major tax proposals would even out these tax rates considerably. The Treasury proposal would provide the most uniform treatment, producing an overall tax rate of 39 percent, and these tax rates would apply at the same level, roughly, for all assets.

These calculations did not take into account the personal statutory rate reductions, so that the levels would actually be slightly less. The reason it wasn't included was because it is very complicated to do those measures for all the proposals.

Similarly, I found proposals introduced in the last Congress by Senator Bradley and Representative Gephardt and by Representative Kemp and Senator Kasten to produce roughly equal tax rates on equipment and structures. Because these proposals did not involve indexation of inventories, the tax burdens on inventories would remain higher than those under depreciable assets.

Neither of the proposals altered the aggregate tax burden in a major way. It is my understanding that the new proposal introduced by Representative Kemp and Senator Kasten will retain even rates across depreciable assets but will lower those rates.

These differential tax rates by asset type lead in turn to differential tax rates by industry classification. In estimates provided earlier to this committee, I calculated that the effective tax rate on combined depreciable assets and inventories was 44 percent for agriculture, 26 percent for mining and oil extraction, 35 percent for construction, 45 percent for manufacturing, 27 percent for transportation, 23 percent for communications, 31 percent for electric and gas utilities, 50 percent for trade, and 36 percent for services.

These differential rates involve a high rate of 50 percent for trade, which is approximately twice the low rate of 23 percent for communications. These estimates indicate that manufacturing actually pays taxes above the average rate, even though many of the tax subsidies were originally aimed at manufacturing.

Calculations were also provided by industry for the Treasury proposals. These proposals would provide more or less uniform rates of around 39 percent across these industries. There is an exception in the case of mining and oil extraction, where some special problems in taxation occur.

The tax rates would fall slightly in the aggregate, but the benefits for manufacturing would be somewhat larger, as the rates fall from 45 to 40 percent.

I would also like to add—this is not in my statement—I would like to stress that these tax measures are long-run, permanent measures of tax burdens. I think you can be misled if you try to judge the level of taxation by the short-run cash-flow effects. As Chuck Hulten mentioned, there is a timing shift here. So these findings are really not inconsistent with initial increases in corporate taxes, which will be offset by decreases later on.

Thank you very much.

[The prepared statement of Dr. Gravelle follows:]

STATEMENT OF DR. JANE G. GRAVELLE ON DIFFERENTIAL EFFECTIVE TAX RATES BY ASSET TYPE AND INDUSTRY

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a specialist in industry analysis and finance in the Economics Division of the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss the issue of differential effective tax rates by asset and industry. My discussion will address not only the presence, causes and consequences of these tax rates, but also the effects of a number of tax proposals on differential tax rates.

Current tax law is characterized by substantial variation in effective tax rates by asset type. In the case of depreciable assets and inventories, which constitute most of the reproducible stock of business capital in the United States, these tax rate differentials arise from three basic tax provisions. The investment tax credit, which is restricted to equipment and certain types of structures, reduces the tax rate on these eligible assets by allowing a credit for part of the cost of purchasing the asset. Furthermore, even if the investment tax credit were allowed on all assets, it would favor short lived assets over long lived ones. The second major tax provision is the use of historical acquisition cost to figure depreciation or cost of goods sold under certain inventory accounting methods, such as first-in, first-out (FIFO). The use of historical cost basis penalizes short lived assets more than long lived ones, and its effects thus offset some effects of the investment credit. Inflation penalties are, however, largest in the case of FIFO inventories. The third type of tax provision is accelerated depreciation, which allows costs to be recovered at a rate faster than the true economic decline of the asset. Accelerated depreciation favors depreciable assets and its favoritism among long and short lived assets depends on its exact form.

These types of distortions are not new to the tax code. The investment credit was first introduced in 1962; inflation has been present at varying rates for many years. The depreciation rules have been changed in number of ways, but the current depreciation rules are clearly designed to recover depreciation over periods that average much shorter than estimated service lives.

The consequences of tax differentials are straightforward. In the absence of some type of market failure, private markets will allocate resources in the most efficient manner. When tax burdens differ by asset type, there are two types of distortionary effects (assuming tax differentials are not addresssing some market failure). First, businesses will use an inefficient mix of assets in their production. Second, capital will be allocated across industries in the wrong amounts and the relative prices of products will not reflect their true resource costs.

The effect of the tax system on different assets depends on the interaction of the effects of investment credits, historical cost basis, and accelerated depreciation. The method of capturing these effects in a single measure for comparison is to measure the effective tax rate on new investment. The technique used is to compare what rate of return a given project would earn if there were no tax payments or benefits -- or the pre-tax return -- with the return it actually earns with the payment of taxes and the receipt of benefits -- or the after-tax return. For example, if the pre-tax return is ten percent and the after-tax return is five percent, the effective tax rate is 50 percent. Out of the pre-tax return of ten percent, one half would be paid in taxes leaving one half, or five percent, as an after-tax return. If the pre-tax and after-tax return are the same -- five percent -- then the effective tax rate is zero. It is possible for the tax rate to become negative when tax subsidies are large enough, and this negative tax rate would simply mean that the value of tax credits and deductions is greater than the value of tax payments.

One can measure, in this fashion, the corporate tax rate, or a combination of corporate and personal tax rates. The measure that best facilitates comparison among different proposals is to measure the total tax burden which includes both corporate and personal taxes. In a recent study I prepared, entitled "A Comparative Anaylsis of Five Tax Proposals: Estimates of Business Income Tax Provisions" (Congressional Research Service, Typed Report 84-832 E, December 27, 1984) estimates of these effective tax rates were prepared for current law and for a number of tax proposals. Under current law, I estimated that the effective tax burden on equipment was 14 percent, the effective tax burden on structures was 39 percent, and the effective tax burden on inventories was 60 percent. The weighted average tax rate was 41 percent. There was, furthermore, additional variation within each general group.

The major tax proposals would even out these rates considerably. The Treasury proposal would provide the most uniform treatment, producing an overall tax rate of 39 percent and these rates would apply at the same level, roughly, for all assets. These calculations did not take into account personal tax rate reductions so that the levels would be slightly less. Similarly, I found the proposals introduced in the last Congress by Senator Bradley and Representative Gephardt and by Representative Kemp and Senator Kasten to produce roughly equal rates on equipment and structures. Because these proposals did not involve indexation of inventories, the tax burdens on inventories would remain higher than those on depreciable assets, however. Neither of the proposals altered the aggregate tax burden in a major way. It is my understanding that the new proposal introduced by Representative Kemp and Senator Kasten will retain even rates across depreciable assets, but will lower those rates.

These differential tax rates by asset type lead, in turn, to differential tax rates by industry classification. In estimates provided earlier to this Committee, I calculated that the effective tax rate on depreciable assets and inventories was 44 percent for agriculture, 26 percent for mining and oil extraction, 35 percent for construction, 45 percent for manufacturing, 27 percent for transportation, 23 percent for communications, 31 percent for electric and gas utilities, 50 percent for trade, and 36 percent for services. These differential rates involve a high rate of 50 percent for trade which is approximately twice the low rate of 23 percent for communications. These estimates indicate that manufacturing actually pays taxes above the average rate, even though many of the tax subsidies were aimed at manufacturing.

Calculations were also provided, by industry, for the Treasury proposals. These proposals would provide more or less uniform rates of around 39 percent across these industries, with the exception of mining and oil extraction, where some special problems of taxation occur. The tax rates would fall slightly in the aggregate, but the benefits for manufacturing would be somewhat larger as the rates fall from 45 to 40 percent.

I thank you for the invitation to appear here today and I will be happy to answer any questions about these estimates.

Figure 13

Effective Tax Rates on New Investment

Industry	Current Law	Treasury Proposal
Agriculture	44%	40%
Mining/Oil & Gas Extraction	26	33
Construction	35	39
Manufacturing	45	40
Transportation	27	39
Communication	23	39
Electric/Gas Utilities	31	38
Trade	50	40
Services	36	39
Overall	41	39

Source: Congressional Research Service. Includes equipment, structures, and inventories and reflects both corporate and personal taxes (but does not consider individual rate reductions). Assumes after-tax real return to creditors is 3.25 percent and tax rate is 25 percent; assumes cost of corporate equity is 7 percent (before personal taxes), dividend return is 4 percent and stockholder tax rate is 35 percent. Financing is assumed to be one-third debt. Inflation rate is set at 5 percent.

Chairman LAFALCE. Just to make sure I understand your position, Ms. Gravelle, you are saying that insofar as the manufacturing sector is concerned, the Treasury tax plan would actually lower the effective tax rate.

Ms. GRAVELLE. That is correct.

Chairman LAFALCE. That is correct, and therein you differ markedly from Mr. Brinner and Mr. Huard, correct?

Ms. GRAVELLE. I am not entirely sure what their position is. It sounds like it.

Chairman LAFALCE. All right.

I am just going to ask two questions, and we will turn it over to the other members of this panel. My first question is: Everybody wants to have a lot of amendments in order to get it perfect according to their vision of the world. But suppose we had to vote on the Treasury tax plan with no amendments.

Ms. Gravelle, how would you vote?

Ms. GRAVELLE. Well, I am not really allowed to answer that question, but let me say that I think the majority of economists have found the Treasury tax proposal to be very close to the practical ideal of the desirable efficient tax system.

Chairman LAFALCE. Good enough. Put her in the "yes" category.

Dr. Brinner.

Mr. BRINNER. Yes.

Chairman LAFALCE. Data Resources is saying that they would vote yes you are saying?

Mr. BRINNER. Roger Brinner.

Chairman LAFALCE. Roger Brinner, chief economist for Data Resources, is saying he would vote yes.

Mr. Hulten?

Mr. HULTEN. Definitely, yes.

Chairman LAFALCE. Definitely, yes.

Mr. Huard.

Mr. HUARD. No.

Chairman LAFALCE. No. Definite or wishy-washy no?

Mr. HUARD. Oh, that is pretty definite.

Chairman LAFALCE. A pretty definite no, all right.

The second question is: What are the areas in which you have most disagreement with what others on the panel have said? Ms. Gravelle.

Ms. GRAVELLE. Well, I think my disagreement is that the tax burden is going up. I think the impression that the corporate tax burden is going up has occurred largely because we are looking at these short-term cash-flows; that is, as you change from accelerated to economic depreciation you have a shift in revenues to the present, which will be offset by reductions in the future.

And, second, there are a lot of provisions included, as Chuck mentioned, in the Treasury proposal which are not likely to impact on business investment. The financial intermediaries will affect other types of investment. The time value of money will primarily affect, as I understand it, defense contractors and regulated utilities. Some of that revenue is from tax burdens on capital invested abroad, due to the per country limitation.

So I guess that is a difference, and I am not sure if we all looked at this carefully enough that there would really be a difference as far as long-term position.

Chairman LaFalce. Mr. Brinner?

Mr. Brinner. The difference between the short- and long-term can be found pretty readily in my handout.

The short-term impact is this 30 percent increase in the taxes paid that I mentioned.

The long-term impact is found, for example, on the table on page 21, where I compare the annual post-tax cost of using different types of capital. The furthest right column indicates that the long-term impacts are an increase on the order of 5 to 10 percent, depending on the industry that you are speaking of and the cost of using capital. That is definitely a long-term impact. It is not a giant impact, as I mentioned, but it is a 5- to 10-percent increase.

Chairman LaFalce. Let me just ask you this. Do you think that this Treasury plan would slow economic growth, or do you think it would—as American Enterprise Institute does—think it would increase economic growth?

Mr. Brinner. I can be qualitative and quantitative. Qualitatively, near term it would slow growth. If you look out a decade, I suspect we would be a little bit higher, and to put it in numbers, I estimate that a decade from now GNP would be a half percent higher.

That is why I indicated in my remarks this is not a plan——

Chairman LaFalce. How much lower might it be short term?

Mr. Brinner. A half point lower short term. This is not a plan that is going to change the face of the American economy from a macroeconomic point of view.

Chairman LaFalce. All right.

Mr. Hulten?

Mr. Hulten. My principal problem with some of the statements that I have heard, both here and elsewhere, centers on the question of what one means by antigrowth.

The effects that we are talking about involve a once-and-for-all change in the user cost of capital. Even if there is a negative impact on some types of equipment, as one might reasonably expect with the removal of the investment tax credit, this is a once-and-for-all change that doesn't permanently affect long-term growth rates.

This distinction is important for interpreting the finding that the level of GNP will be half a percent higher a decade from now. As I understand it. This does not mean that there will be a permanent change in the growth rate of the economy.

Furthermore, if you look at the historical determinants of the growth rate of the American economy, you will find that capital formation is not the most important determinant. According to the Bureau of Labor Statistics, the most important determinant of post-war growth is a quantity called total factor productivity. This is the efficiency with which inputs are used. Now, productivity is related in some very complicated ways to capital formation, but I do not think that you can establish a very tight link between the two.

So, if we are concerned about improving the rate of American economic growth we shouldn't give undue weight to capital formation.

Chairman **LaFalce**. Thank you.

Mr. Huard?

Mr. **Huard**. Well, I guess my biggest area of disagreement from what I have heard this morning is the relative comfort level people have with the long term and the relative disdain they have for what happens in the short run.

As John Maynard Keynes said, "In the long run we are all dead." And I think we have to be concerned with what happens over the next 5 years.

I think when you have got a trade deficit the size of the trade deficit we have, and when you consider the fact that the single biggest component of the trade deficit is the trade deficit in manufactured goods, you have to be concerned with what happens over the next 5 years.

I guess I suffer from being encumbered with a legal education, and I tend to be more worried about what will happen in practice than what should happen in theory, but I think the biggest problem is how you get from here to there. And these things may be very nice and very elegant, but you know, I would think that a concern over the level playing field has to be tempered with a real world concern over how we compete in the world economy.

And, indeed, going back to the level playing field concept, what good does it do us to give us a level playing field within the boundaries of the United States when we have totally distorted the playing field when you look at the world picture.

Chairman **LaFalce**. Paul, just one clarification if I might.

When I earlier asked if NAM had a position on tax simplification, you said, yes, we favor tax simplification, and that is an NAM position. But when I asked whether you would vote yes or no, Roger pointed out he was speaking for himself, not for Data Resources. When you voted no, were you speaking for yourself or for NAM?

It is my understanding that NAM does not have an official position for or against the bill. Do they have an official position opposed?

Mr. **Huard**. We don't, but I can't answer your question any other way.

Chairman **LaFalce**. Fine, OK. So you don't have an official position?

Mr. **Huard**. We support parts of the bill, we oppose parts of it.

Chairman **LaFalce**. Fine.

Mr. **Huard**. Your question was framed, if I had to take the whole bill as is.

Chairman **LaFalce**. That is right. So you were speaking for yourself?

I just want to clarify that.

Mr. **Huard**. No, I was speaking for the association. I mean, if there are parts of the bill we support and parts we oppose, and we have to take the whole thing, we would vote no.

Chairman **LaFalce**. All right, fine. Thank you.

Mr. Dreier.

Mr. **Dreier**. Thank you very much, Mr. Chairman. I would like to compliment you on holding these hearings. It is very exciting for me to see an issue which has bipartisan interest.

I thank the panelists for their excellent testimony. I am a little concerned that by a 3-to-1 margin the Treasury proposal has just become law in the eyes of this panel.

I would like to ask about——

Chairman **LaFalce**. If you count the three witnesses we had 2 weeks ago, it goes up to 6-to-1.

Mr. **Dreier**. 6-to-1.

That is even more disconcerting, Mr. Chairman.

I would like to ask about a couple of the other——

Chairman **LaFalce**. We selected the witnesses, of course. [Laughter.]

Mr. **Dreier**. I didn't select the witnesses.

Mr. **Huard**. What if you factor out the economists? [Laughter.]

Mr. **Dreier**. I would like to ask about a couple of the other proposals that are before us. First of all, maybe the panel could offer the same kind of vote on both the Kemp-Kasten plan and then on the Bradley-Gephardt proposal, and we begin ladies first as far as I am concerned, even though you are not allowed to answer that question.

Ms. **Gravelle**. Well, I think that, judging by the efficiency effects, all of the major tax reform proposals offered last year and this year seem to be moving in the direction of more efficiency.

The Bradley-Gephardt and last year's Kemp-Kasten plan produce very even tax rates across industries and across most assets. They didn't index inventories. That was the major difference as far as assets.

Mr. **Dreier**. Now, if you have to make a choice between the three proposals before us, which one would you select?

Ms. **Gravelle**. Well, let me try to answer that question the same way that I answered the first one.

Mr. **Dreier**. By saying you can't answer it?

Ms. **Gravelle**. I would say the Treasury proposal moves closer to the ideal of an efficient, nondistorting tax system than the other proposals. But that does not denigrate the efficiency potential in the other proposals. They are all moving very much in the direction of more even taxation.

Mr. **Brinner**. I am not thoroughly familiar with the revised Kemp-Kasten bill, but I may surprise people, having worked in the Carter administration and being the chief economist of a group that many people think is anti-supply side. I would favor the Kemp-Kasten, among the three plans, but just by a narrow margin. And I would rank Bradley-Gephardt last.

Mr. **Dreier**. Mr. Hulten.

Mr. **Hulten**. I think the Bradley-Gephardt proposal is very similar in its overall impacts to the Treasury proposal. On balance, I favor the Treasury proposal because of the way it treats depreciation. I would rank the Kemp-Kasten plan a clear last.

Mr. **Dreier**. Thank you. Mr. Huard.

Mr. **Huard**. Generally speaking, we have problems with all three plans, but it is pretty clear to us that the worst is the Bradley-Gephardt plan, which has relatively few redeeming characteristics. The

Treasury plan is sort of in the middle, at least, they have a lot of good things in it. I think by far the best is the Kemp-Kasten plan, which provides a much more realistic treatment of capital formation and doesn't get into a lot of strictly losing propositions like trying to tax employee benefits, you know, at least they have a much more politically realistic plan.

Mr. DREIER. Last November, the term "word processor" took on a very expanded meaning when then Treasury Secretary Regan said that the Treasury proposal had been drawn up on a word processor and could be changed. Now we have a new Secretary of the Treasury, and there is rumor that the Treasury proposal is in the process of being changed, specifically in the area of depreciation. I wonder if any of you would like to comment on what your prognostication would be as to what the changes will look like.

Mr. BRINNER. I believe that it is unlikely that the Treasury will come out with a plan that for the short term raises corporate taxes by 30 percent. I think there will be some adjustment of the marginal rates. There was a report in the Wall Street Journal not too many days ago, that said that the original Treasury plan, never released, actually was neutral for the personal side and the corporate side, but because it had such awkward personal tax rates, not round numbers, and so forth, that it was shifted to 15, 20, 25, 35, and then to make the whole system revenue neutral, you had to raise corporate taxes. I would, just on the basis of this being a Republican administration, predict that the final plan will not have a near term 30-percent increase in corporate taxes.

Mr. DREIER. Are any of you aware of exactly what percentage of corporations totally eliminated their tax liability through ACRS, ITC?

Ms. GRAVELLE. Let me say it's rather hard to gather statistics on that, because there are many, many corporations that just plain don't make money. They are new corporations, and they don't make any kind of money, so they don't pay taxes. It's very hard to answer that question, statistically, really.

Mr. DREIER. I don't know if all of you have seen it, but I would like to recommend to you reading the "Harris Bank Study" on tax reforms. It heavily favors the Kemp-Kasten proposal, and I would like to ask unanimous consent that this proposal be included in the record, if I may, Mr. Chairman.

Chairman LAFALCE. Without objection, so ordered. Of course, we will leave the record open for an equal number of articles that favor Treasury or Bradley-Gephardt, in order to get a different perspective.

Mr. DREIER. Unless there is an objection; right?

Chairman LAFALCE. Unless there is an objection.

Mr. DREIER. Thank you very much, Mr. Chairman.

[The material referred to above may be found on p. 249.]

Chairman LAFALCE. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman. I too would like to congratulate you on holding these hearings. I think it does the Congress a great service to go ahead and explore some of these issues before public debate warms up any more.

I would like to direct my questions mainly to Mr. Huard, since you seem to be in more disagreement with the other panelists than anyone else, and first let me say, I appreciate your willingness to be here, because it is good for us to get differing prospectives.

Mr. Dreier earlier mentioned the existence of some corporations that don't pay any tax. There have been several egregious examples of that. For example, as I understand it, General Electric, for 2 years recently, didn't pay any tax at all.

Does the NAM have any position at all on a company like GE that is a substantial legitimate American company that doesn't pay any taxes?

Mr. HUARD. We don't think that any oblique should attach to General Electric using existing laws, perfectly legitimately, to reduce their tax liability in the manner they have. They have not done anything illegal.

Chairman LAFALCE. Let me interrupt for a second to say the subcommittee will not recess. We want to keep going. If Members want to go over and vote and come back, we're going to be keeping the discussion going.

Mr. HUARD. I mean, the reason they didn't pay any tax is because they engaged in activity that Congress encouraged them to engage in through the Tax Code.

Mr. COOPER. I am not suggesting that they did anything illegal. I am just wondering as a policy matter whether NAM has any policy regarding—perhaps GE is a member of your association.

Mr. HUARD. Oh, they certainly are.

Mr. COOPER. Do you have any policy whatsoever regarding companies like that which choose to exploit the tax laws to their fullest, and as a result, end up paying no tax whatsoever?

Mr. HUARD. No, we don't.

Mr. COOPER. Have no policy. OK.

In your testimony, I believe you say that the individual side, you basically have no real objection to, but overall, you would shoot down the Treasury and the other proposals, because they would hurt the corporate side.

Is it possible to unscramble the egg? Is it possible to have any sort of individual tax simplification procedure and yet preserve a lot of the benefits that you are seeking to preserve on the corporate side?

Mr. HUARD. Oh, I think it is. You have to make a distinction between concepts and rates. The concepts of the Treasury plan on the individual side are in many respects perfectly good concepts. The question is, when you have designed the plan and you have the concepts in place that you want to have, then you superimpose the rate structure.

Well, how you set the rate structure will determine whether or not you can unscramble the egg. If you set the rate structure by dragging over $165 billion from the corporate side, in order to finance rate reduction on the individual side, you have got a plan that we can't support, but you could leave the concepts of the individual side of the plan and raise the rates from 15, 25, 35, a very moderate amount, 1 point per bracket, 16, 26, 36, and the plan would then be approximately revenue neutral as between the individual income tax and the corporate income tax.

Mr. COOPER. Would you support a revision of the plan like that?

Mr. HUARD. Oh, absolutely. I mean this has been our No. 1 priority in all of our negotiations with Treasury is to end the cross subsidy and make both parts of the package revenue-neutral, so that both the individual tax and the corporate tax raised neither more or less than they currently raise.

Mr. COOPER. And then you would keep, basically, the status quo on the corporate side?

Mr. HUARD. No, that would not be possible. Bringing back $165 billion doesn't give you enough money to fully restore the investment tax credit and ACRS. You would have to make some other, you know, adjustments. And you know, we have an open mind on that. We are quite willing to see what Treasury comes up with in Treasury II.

Mr. COOPER. I have lost track of the tax expenditure debate since law school in college. I don't suppose NAM has any sort of official feeling on whether the tax expenditure theory is valid or invalid, does it?

Mr. HUARD. We don't have an official position on it. Personally, I am fairly skeptical of it, particularly when you include things like depreciation as an expenditure. You ought to be able to recover your capital investment.

Mr. COOPER. Mr. Brinner, do you want to interject?

Mr. BRINNER. On the tax expenditure issue, I think one useful way of viewing the Treasury proposal is that it says let's get the tax system out of the decisions. It's silent on the issue of whether through the expenditure side of the ledger, we might want to subsidize equipment, R&D structures. So one way to make this whole thing aboveboard, would be to do the Treasury reform plan, and then if you feel that you have hampered equipment investment or any type of investment, go put it on the expenditure side of the board through a direct subsidy.

Mr. COOPER. Amen!

Is the NAM in favor of any sort of direct subsidy?

Mr. HUARD. Direct subsidy for what?

Mr. COOPER. Well, assuming the Treasury law was passed, and as Mr. Brinner suggests, then if you want investment tax credit money, would the NAM favor any sort of direct cash payment from the government to its members to be equivalent of what they are seeking right now, in terms of tax breaks? Is the NAM, in other words, afraid of a direct cash Government payment to its members to make up the difference between what they're receiving now and what they would get under the Treasury proposal?

Mr. HUARD. We would probably have some problems with that.

Mr. COOPER. Ideologically or practically.

Mr. HUARD. Both, I guess. The problem with the direct subsidy, of course, is you would get it if you had any profits or not. Our position on the investment tax credit, historically, has been that it should not be a refundable credit. It should be available to offset tax liability, and that it should not be, you know, if you have no tax liability, you just should get cash in hand from the Government, which is what you'd get. What you're talking about is not functionally distinct from a refundable credit. One way you apply for it and you get a check. The other way you do it on your tax return, and you get a check, but either way it's——

Chairman **LaFalce**. The gentleman's time has expired. Mr. McCandless wants to ask one question before he goes over for a vote. Mr. McCandless.

Mr. **McCandless**. Thank you, Mr. Chairman. As I read this whole scenario, it is the bottom of the ninth, the score is 6 to 1, and the Treasury is ahead.

With that in mind then, what do you feel the impact on jobs and the level of employment will have, based on this scenario? Will there be a jobs decrease? Will there be an increase in jobs? Will it stay the same? How do we see that?

Mr. **Huard**. I think there would be a lot of jobs exported, if the Treasury bill were enacted, but I don't think the Treasury bill has a ghost of a chance of being enacted in anything like its present form.

Mr. **Brinner**. In line with my earlier view that there is not going to be a giant change in output, my tables indicated a quarter point loss near term and a quarter point, percentage point gain, medium term. The lower real wages from the greater labor supply from the married women joining the labor force would help expand employment marginally.

Ms. **Gravelle**. I think it is probably worth adding too, that if there were some adverse consequences in the short run, we have lots of ways to try to offset that through standard macroeconomic policies. I think that really relates to this transition issue, that there are lots of ways to get from here to there, sort of softening the consequences.

Mr. **Hulten**. I agree with Roger Brinner that there would probably be a slight increase in the long run. I think it is also worth noting that by reducing the tax burden on inventories, the Treasury plan tends to help those sectors which are fairly strong employers of labor.

Mr. **McCandless**. Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you. Ms. Gravelle and gentlemen, I too, am at least uncertain that the Treasury bill or anything close to it is going to pass this session or this Congress. The nature of Congress is not to act in such a large scope, especially so shortly after bills have been introduced. There is a certain gestation period that is usually required, and we might proceed incrementally.

Now if I am correct in that assessment, and yet we do want to take certain features of the Treasury proposal, and if we are also able to convince a majority of the Congress and, most importantly, the President of the United States that deficit reduction is of greater urgency than tax reform, but that we ought to accompany the two, what provison of the Treasury plan would you most be interested in seeing adopted in order to increase revenues, in order to reduce the deficit? Ms. Gravelle.

I have a personal favorite, it happens to be the investment tax credit, but I will let you people——

Ms. **Gravelle**. Well, again, I can't make choices like that, but let me say that the single provision that probably contributes the most distortions among assets in industries is the investment tax credit. It is a very uneven provision, in that respect, and so if you were judging by efficiency gain, that is probably the provision you would pick.

Chairman LaFalce. Mr. Brinner.

Mr. Brinner. I feel that the Treasury plan is very carefully constructed as a whole, and to take any piece out of it is going to lose the efficiency gains it is trying to buy.

Chairman LaFalce. Then let me ask you the question in a different way. Forget about the Treasury plan. Suppose we just wanted to make some changes in the Tax Code, in order to increase revenues. What would your chief suggestion be?

Mr. Brinner. A surtax on all tax payments, corporate and personal. I would like to see something like the comprehensive plan put in, and so rather than take it piecemeal, put a surtax on.

Chairman LaFalce. All right. Fine. What about a limitation—close to what you would do, but a limitation on all deductions, credits, and exemptions or just deductions and credits. By "limitation," I mean 90 percent of their value, something like that.

It's a little bit different than a surtax, but it's sort of close.

Mr. Brinner. All right. I haven't done any detailed analysis. My feeling is that many of those are legitimate. The Treasury has eliminated some and kept others, so that—I worry about—if you do that, it takes the pressure off of total reform, so again, I would vote against that, and I would also strongly vote against removal of the investment tax credit. That has the biggest bang for the buck of any incentive to capital formation, and hence, macroeconomic—short-term growth, as well as long-term growth. That's my favorite rather than my least favorite part of the Tax Code.

Chairman LaFalce. It's interesting. I read in the Wall Street Journal last week a statement by a noted conservative Congressman that "Virtually everybody agrees the investment tax credit has to go."

Did you read that statement?

Mr. Brinner. I did, and I believe that is a political statement. The investment tax credit is not widely understood anymore, what it is trying to achieve. To go along with this notion, I would support the notion of putting on the expenditure side of the budget rather than on the tax side, make it——

Chairman LaFalce. How would you do that? A National Development Bank?

Mr. Brinner. No. I would simply have a 10-percent subsidy for qualified investment. I might narrow the range.

Chairman LaFalce. Somebody would have to give it, though. I mean, some entity would have to be created or used, in order to give it.

Mr. Brinner. It could be administered by the Internal Revenue Service, paid by the Treasury.

Chairman LaFalce. Some entity—Commerce, EDA, et cetera. Mr. Hulten?

Mr. Hulten. Yes, I also like the idea of the surtax as a means of raising revenue. One of the advantages of the Treasury plan is that it broadens the tax base and supports the effort to raise revenue without having to impose very large rate increases.

Mr. Huard. I think it would be a mistake to dismember a reform package and just select out a piece like the investment tax credit to raise revenue. I think one of the biggest tax policy mistakes we could make, would be to abolish what Dr. Brinner has referred to as probably the most effective capital formation tool in return for no reform, no rate reduction, no dividend deductibility.

If the Congress feels the pressing need to raise revenues to reduce the deficit, our position is very strongly that Congress should look at something like a broadbased consumption tax, which would be applied as broadly across the economy as possible, as a way to raise revenue.

This would reverse basically any gregious imbalance in the distribution or the source of Government revenues. Presently, the United States raises about 93 percent of its total revenues from the two income taxes and the Social Security tax. This is a percentage that's way out of line with the distribution.

Ms. **Kaptur**. Mr. Huard, in terms of a consumption tax, have you ever seen any proposals drafted over in the other body or here that particularly interest you in that regard?

Mr. **Huard**. Congressman Ullman had a proposal which was, you know, I don't remember all of the specific details but, as I recall, it was relatively broadbased. There's never been any other proposal in recent times that I'm aware of that's actually gone to the drafting stage.

Ms. **Kaptur**. I might just parenthetically say, that I don't think Congressman Carper has had a chance to ask questions—am I correct?—that what has surprised me about the tax debate to date is how it's all on the income tax side, and that the consumption tax portion of this debate has somehow fallen out of the discussion.

Mr. **Huard**. Well, there's an ideological problem there. Frankly, if you read the Treasury report very closely, they have an entire volume on consumption taxation or value-added taxation. When all the smoke clears, it appears that their biggest objection to that kind of tax is it's much too effective at raising money. And, frankly, I think there is an ideological problem. I think there is a segment within the Congress who would probably prefer to starve the Congress of revenues, and that they are basically antipathetic to any effective device to raise money.

Mr. **Carper**. I wanted to ask Ms. Gravelle, did you have a comment on that consumption tax? I saw you smile.

Ms. **Gravelle**. Well, I think that the consumption tax is something that a lot of economists think well of in terms of its potential efficiency gains, but there are tremendous practical problems we would face if we are going to consider a consumption tax.

For example, under a consumption tax, you would have people who have accumulated income and capital under an income tax. If you suddenly switch now and tax them under consumption tax, you are either going to tax them twice or you're going to have to introduce some very complicated transition rules.

The other thing about a consumption tax is it says that over your life cycle you are going to tax people by their consumption pattern, which means that elderly people will be taxed at higher rates and young people just starting off, or students, will be taxed at higher rates, compared to an income tax of the same yield.

While that may sound as if it doesn't matter which period in your life you pay taxes—in fact, I think that would present some very serious political difficulties once people realized what was going to happen under a consumption tax.

So the fact that no one—that the Treasury really did not come out with a consumption tax, a substitute consumption tax, I suspect reflects the recognition of some of those difficulties.

Mr. **Huard**. Let me clarify my comments. Jane and I are talking about two different kinds of taxes. She is talking about a cash flow expenditure tax or a consumed income tax, where you get a net deduction for all your savings and investment. That is not the kind of tax I am talking about. I am talking about a VAT or a sales tax, or something that is a transaction-based tax which, properly designed, is one of the easiest things in the world to do.

I agree with her. The consumed income type of approach, the transitional rules and the fairness issues about people who have saved money under the old system and now they spend it under the new system are just abysmal. I don't think we could get from here to there on a consumed income type of tax.

Ms. **Kaptur**. I just wanted to ask each of you to respond to a question. If you take a couple of the industries in our country that are truly troubled—for example, basic manufacturing industries such as steel or machine tools, and you try to ascertain the short-term versus long-term impact on each of those industries under the Treasury proposal, I was trying to read through some of the charts that you have provided here.

Could each of you summarize for me what the first 5-year impact might be let's say, on Bethlehem Steel or Chrysler Corp., under the Treasury proposal?

Ms. **Gravelle**. I would find that very difficult to say because my model is not set up to deal with that. But there are two offsetting effects, which is how much the interest rate is going to fall—that will depend on capital inflows and outflows—and how much the exchange rate changes.

Those are the two factors to measure. And, in the short-term, I think I would find them very difficult to assess, to answer that question. Maybe Roger has a better answer.

Mr. **Brinner**. Table 7 on page 7, that lays out the impacts by type of spending, would give you some suggestion of which companies would be hurt more and which would be helped.

Firms that produce goods that are dominantly used for the nondurable consumer sector are going to benefit. Firms that produce steel will benefit from the extra consumer income to spend on cars and washing machines, and so forth, but they will lose from the drop in the equipment demand.

I believe I can provide you with these numbers because we do break this down to production by two digit industry. I believe that there is no industry that has a loss greater than 5 percent in the near term, as a result of a switch to the Treasury package.

Your selection of industries also indicates to me an awareness of which firms have been devastated by the strong dollar. I share your chairman's comments that the thing we have to do is cure the deficit to get interest rates and, hence, the dollar down.

Chairman Volcker of the Federal Reserve Board has testified that every $50 billion of deficit reduction would bring a full point reduction in interest rates. I buy that estimate. I also believe that there's good evidence that every point that interest rates drop would bring at least a 5- and perhaps a 10-percent drop in the exchange rate, which is now about 40 percent too high.

Ms. **Kaptur**. How many of the problems of the industries I cited predated the trade deficit problem?

Mr. **Brinner**. Most of them were still making profits in 1980.

Ms. **Kaptur**. Their problems have been made worse by the overvalued dollar. But if you look at the condition of capital plants in many of them, I guess what concerns me as a member of this committee, and as a Member of the House, is that I don't want to do anything to hurt any of those industries, which I think badly need massive infusions of capital investment if they are going to be competitive at all.

So, Mr. Hulten, I am going to be over my 5 minutes here.

Mr. **Hulten**. It's probably the case that many of the firms that you describe don't have a lot of taxable income right now. In fact——

Ms. **Kaptur**. That's right.

Mr. **Hulten**. In fact, many of them, I suspect, have substantial operating losses to carry forward. So, to answer your question about the next 5 years, I would guess that many of them wouldn't be directly affected by the Treasury plan.

The longer term prospects are somewhat more difficult to judge. Most of the analysis that I and others have done has examined a prototypical firm that is profitable. What tax reform does for seriously distressed firms in the long-run is a little hard to say.

I'd also offer the thought that for many of these industries, future output demand is a more important determinant of industry and company health than are tax incentives.

Mr. **Brinner**. I'd second that but note that those firms that Mr. Hulten has mentioned would not be affected through the tax law changes would be affected short term through the demand changes. And if you take an equipment manufacturer that doesn't have his risk diversified by being in consumer durables, he is going to be hurt by the transition, period, because of the removal of the ITC. There's no doubt about that.

Ms. **Kaptur**. Mr. Huard.

Mr. **Huard**. My comments are essentially the same.

Ms. **Kaptur**. Thank you.

Chairman **LaFalce**. Representative Carper.

Mr. **Carper**. Thank you, Mr. Chairman. I would like to welcome our guests, and thank you very much for your testimony today.

I want to ask each of you a question; we will make ladies last on this round, if you don't mind. [Laughter.]

The question is: Should a tax reform plan, if any is adopted, be revenue neutral?

I will start with our friend on my left, Mr. Huard.

Mr. **Huard**. Well, you know, I think that, at worst, it should be revenue neutral. At best, it should probably lose money, which is why I think it's more important for the Congress to address the deficit issue and to get the spending problem cleaned up before addressing the issue of tax reform.

Again, I am speaking more from a pragmatic and political viewpoint than an economic or a theoretical viewpoint. I tend to agree very strongly with the comment of Barber Conable, until recently a distinguished Member of the Congress, that people don't consider tax reform to be reform if it raises their taxes.

So, basically, your prospects for achieving tax reform, politically, in any event, are much higher if virtually everybody's taxes are coming down. Now you really can't do that.

All of the plans that are now on the table that are revenue neutral have various ratios of winners to losers. Now, the Treasury, mostly by cross-subsidizing the individual side from the corporate side, has probably got the best ratio of winners to losers of anybody.

But, nevertheless, you know, there are major political problems inherent in that plan. For instance, it very heavily taxes employee fringe benefits, and there's a lot of revenue tied up in that. And I think it's very unrealistic to assume that that part of the plan would hold.

So what happens is you have now got a plan that loses *x* billion of revenue and you have to go fix it. Well, as long as you play this revenue neutral game, it is like pushing down on one corner of a waterbed, the other three corners go up. Everytime you fix somebody's problem, you're going to hurt somebody else, because you've got to make up the revenue.

Again, I think that a much more realistic approach might be to take care of the deficit problem first to the maximum extent possible on the spending side, and to broaden the horizon of the reform effort to include consideration of some kind of broad-based consumption tax as a way to make up the revenue you lose from sensible reform of the income tax system.

Mr. CARPER. Thank you. Mr. Hulten.

Mr. HULTEN. Yes; I think it's too bad this isn't 1981 and we are considering the Treasury proposal instead of the 1981 Tax Act. Then, we could focus on the structural merits of the plan without having to focus on raising revenue.

But that's not possible now. We have to look at any tax reform in terms of its revenue adequacy, and I think the Treasury plan does quite well in this regard. By broadening the tax base, the Treasury plan makes it easier to raise revenue, both because a smaller rate change is needed and because I think people are more willing to accept a tax increase in a tax system they consider fair.

Mr. BRINNER. I believe that the tax reform or tax restructuring should amount to a tax increase of approximately 10 percent for both corporate and personal, be neutral in its increase between the two but, by 1990, I would hope that it would add about 10 percent to both corporate and personal taxes, while, at the same time, we cut expenditures relative to the current policy by about 20 percent.

Mr. CARPER. Thank you. Ms. Gravelle.

Ms. GRAVELLE. Well, I want to say two things. First, I think that there is a current short-term problem with the deficit and there's only two ways you can do something about that, raising taxes or cutting spending. And depending upon what kind of constraints you see on those, it may be that a tax increase is quite important.

I think also though that there are different timeframes to these issues. Closing the deficit is quite important for the short-term, but tax reform offers a potential for efficiency gains, gains in our welfare that are going to go on indefinitely and, I think, are quite significant.

So I think just sort of putting tax reform aside because you want to focus on the deficit is taking a different perspective, and I think the long-term perspective--I mean, maybe we will all be dead, but, presumably, our children will be around—is an important thing to consider.

Mr. CARPER. Mr. Chairman, do I have time for one more question? Good. Thank you.

I don't know that I have heard any of you talking about taxing foreign earnings of American corporations and how we should change the way we do that, if at all. I would like to reverse the order of the witnesses and ask you to comment.

What do you think we ought to be doing along those lines? Some people would suggest that our current tax policy almost exports jobs.

Ms. GRAVELLE. Excuse me, could you repeat that?

Mr. CARPER. There are some people who suggest that our current tax policy, and the way we treat foreign earnings of American corporations, encourages the exportation of American jobs abroad.

Ms. GRAVELLE. Well, I guess I would say, in the long run, we ought to be able to employ all of the people who want employment. The issues are whether we have an efficient disposition of our capital investment, and there is a standard rule on that which says that we ought to treat our investment abroad the same way we do in the United States. We don't do that at the present, for a variety of reasons.

We favor investment in low-tax countries. We discourage investment in high-tax countries, in some cases. So one approach is to try to move those closer together. And I think that's another thing that the Treasury proposal is doing, not only by changing the tax incentives but also by their going to the per country limitation.

Mr. CARPER. All right, thank you.

Mr. BRINNER. That is not an area that I really have studied carefully enough that I could offer a useful opinion.

Mr. CARPER. That's a refreshing answer. Thank you. [Laughter.]

Mr. HULTEN. I will make it two in a row. [Laughter.]

Mr. CARPER. Who says that there aren't honest economists? Right?

Mr. HUARD. I would, I guess, take the other side of the issue of Jane. I don't think our current system of deferral, as it's called, combined with the foreign tax credit, is particularly distortive and I don't think that it's ever been proved that it exports jobs. One of the reasons companies build manufacturing facilities overseas is frequently that's the best place to build them.

You know, there are certain things you manufacture—take pharmaceutical companies—it doesn't pay to manufacture pharmaceuticals in the United States and ship them and sell them in Belgium. I mean, the things, the little pills, don't weigh very much and it is much more effective to manufacture them overseas and sell them overseas because you can sell them at a lower price because you haven't incurred a ridiculous amount of shipping costs.

So there are numerous nontax decisions that relate to the disposition of investment overseas. And I don't think the current system of deferral of taxation on foreign source income until it's actually repatriated is a bad system, and we continue to support that system.

Mr. **Carper**. Thank you all.

Chairman **LaFalce**. Mr. McMillan?

Mr. **McMillan**. Thank you, Mr. Chairman. I'm a member of two minorities in this Congress. One is the Republican minority, the other is the minority of people who have come out of the business world. I think there's some 170 of us. I have been in business, manufacturing and service industry since 1958, with the initiation of investment tax credit and the whole host of changes over that period of time.

One of the appealing things about tax reform to me is to get back to some fundamentals and clear up some areas that have been a football for at least the 25 years of my business experience. So, predictability, it seems, has a great deal of value. A number of important concerns have been raised by you today about the Treasury's proposal. But, focusing on the question of capital recovery and all of the aspects of the proposed changes that would impact that, and some of you perhaps would accept it as is, but would each of you comment on:

If you had a chance to change it, if you could tell Secretary Baker what to come up with next in revision, what would you do?

Mr. **Huard**. Well, in an ideal world, I would be perfectly inclined to go along with a certain amount of neutrality, which some people find desirable, and I would choose expensing, which is perfectly neutral.

Mr. **Hulten**. I would urge him to hold fast to the system, the current Treasury proposal.

Mr. **Brinner**. You are speaking just with respect to the depreciation allowance?

Mr. **McMillan**. Well, principally, depreciation, but to the extent that other changes such as the combination of the lower tax rate, the dividend credit, all as they impact capital formation.

Mr. **Brinner**. I believe that the dividend credit is a very important piece to equilibrate the cost of debt and equity. I would definitely keep that. I like the notion of a real cost recovery system because then the corporation knows it can plan on the real value of those depreciation allowances independent of OPEC oil shocks or farm crises, or a tough Fed policy. It can plan on an environment like that. So I like that.

The combination though, as I indicated, does raise the cost of using capital, simply because we are swinging these billions from the personal side to the corporate side. And that's the piece that I oppose.

Mr. **McMillan**. Let me, could I, before I get to you on that point, you mentioned that you saw in here the possibility of revenue enhancement over 10 years, I believe you said, of close to $70 billion, or some 10 percent?

Mr. **Brinner**. Actually, I am not sure which number you are referring to. I, in response to the earlier Congressman's question on how I would change the whole package, I said that I would prefer to have a package which does raise revenue.

That means that I would have more taxes coming out of the personal side and less out of the corporate side than is in the current Treasury plan.

Mr. McMILLAN. Well, perhaps I misunderstood you. I thought you said that you saw revenue enhancement in this entire package of some $70 billion, I believe you said, over 10 years.

Mr. BRINNER. This was the deficit reduction that comes through lower interest payments by the Federal Government.

Mr. McMILLAN. OK. Excuse me.

While the same corporation, or let's say it may tend to be revenue neutral for certain types of industries, it clearly is not revenue neutral in terms of the change on certain other industries, which the presumption is are undertaxed, or inequitably taxed in the present system.

Isn't that true?

Mr. BRINNER. As I said in my opening remarks, this Treasury proposal is novel because it says there's no role for incentives or differential treatment. That is a basic philosophical statement. Congress, I think, is being accused of too much cynicism if one says that all of those differential tax treatments are purely the results of lobbying.

A lot of those are the result of decisions to promote something such as producer to equipment expenditures.

Ms. GRAVELLE. Well, I have a very simple suggestion. I would suggest that he put out a table that shows the corporate tax receipts for 20 or 30 years instead of 5 years and relate them as a percentage of corporate profits.

I think there has been tremendous misunderstanding about this proposal because of the confusion of the cash flow, short-term cash flow effects with the long-run effects. And it could all be cleared up with some numbers, I suspect.

Mr. McMILLAN. What would that demonstrate, in your judgment?

Ms. GRAVELLE. Well, I think you would find that while corporate tax receipts go up in the short run, I am fairly sure that they would fall in the long run. They would clearly, if you exclude the special areas, the financial intermediaries, I think you would clearly find that this is a tax cut for the corporate sector. I think that is obscured by the fact that substituting economic depreciation for accelerated appreciation costs is just a timing difference largely, and not much of a present value difference.

Mr. BRINNER. The numbers are there. It does make a present value difference; they are lower than under the current system. As I indicated, on a real present value, the proposal would cut the value depreciation allowances by one-quarter to one-third.

I have also given in my tables what the change in corporate tax would be giving all the interactive effects. The biggest increase would be approximately 5 years from now when there would be a $60 billion plus. By the time you get out of the decade, that's down to around $40 billion, and it would narrow.

But on the depreciation effect, it's clear. The present value is lower.

Ms. GRAVELLE. I don't disagree with that. It's lower but that's only a piece of the whole picture. And if you took those revenue losses over a long period of time, I think you would get a more accurate picture of the combined effects of depreciation rate cuts, dividend deductions, and so on.

Mr. BRINNER. The combined effect is, as I have noted earlier, on page 22, an increase of approximately 5 to 10 percent on a long-term steady State basis.

Mr. MCMILLAN. When you look at the long-range figures, there's an implicit assumption that that stream of deductions will actually come to pass. More specifically, there's an implicit assumption that a Congress which has shown a marked inability to keep its hand off the capital recovery system for more than 48 months at a stretch will actually let you have a 17- or 25- or 38- or 63-year stream of deductions untouched, particularly if inflation suddenly rears its head again and you have a large amount of these deductions in the pipeline and all of a sudden the corporate income tax starts to disappear. I wouldn't bet a nickel on that assumption.

Mr. MCMILLAN. Well, I am concerned at your remark on that because it is precisely because of the shifting sand that the corporate world has had to deal with respect to depreciation, capital recovery, that it seems to make some sense to me to try to get it set on some bedrock of economic life adjusted for inflation that would remove it from the political sphere.

Mr. BRINNER. You would not lose the corporate tax base because the Treasury proposal as an integrated package does address interest payments, too. You subtract out the inflation component of those. The Treasury proposal is almost unique among tax reform proposals, recognizes that you not only have to adjust the fixed asset base for inflation, you also have to adjust the debt obligations that are behind those by making this inflation adjustment.

Chairman LAFALCE. That is Treasury, that's not Kemp-Kasten though.

Mr. BRINNER. Yes, that's correct. I don't know the current Kemp-Kasten so I shouldn't say——

Chairman LAFALCE. Wasn't that one of the most grievous deficiencies of that bill, that it made no adjustment for that debt, at least the first bill?

Mr. BRINNER. I believe that is correct.

Mr. MCMILLAN. Thank you, Mr. Chairman.

Chairman LAFALCE. Ms. Gravelle and gentlemen, I want to thank all four of you for what I think has been an outstanding hearing. I could go on and ask another additional 100 questions, but I already think I asked my first 100, and I ought to be satisfied with that during the course of one hearing.

You have given considerable food for thought regarding the impact of the Treasury plan on the manufacturing sector, and I do hope that every Member of Congress who is interested in this subject will avail themselves of the wisdom that we have been able to get from you during today's hearing.

Thank you very, very much.

[Whereupon, the meeting was adjourned subject to the call of the Chair.]

[The following additional material was submitted for inclusion in the record:]

Statement of the Honorable Norman D. Shumway

March 28, 1985

Hearing on Tax Simplification and Manufacturing Industries

Thank you, Mr. Chairman. I would like to welcome our witnesses, whose testimony today will undoubtedly shed some light on how the tax code impacts on the growth, productivity and competitiveness of the capital intensive manufacturing sector of the U.S. economy, and what effects the Treasury's sweeping proposal will have in this regard.

The issue of tax simplification now shares the political center stage with that of the inordinate federal deficit. There is little doubt that in using these two items -- that is, direct subsidies and tax incentives -- the federal government has intervened into and shaped the development of almost every sector of the American economy. I think we can all agree that in so doing, the government has helped thousands of constituencies, including businesses, people, and various regions of the country, by stimulating activities deemed to be "desirable." At the same time, however, we hear the contention that this process has so distorted choices that Americans now respond more to so-called federal subsidies than to a free market, the very concept on which our economy is based.

Now, we hear the cry for a return to a more neutral and less intrusive tax system, that is, one which is to be used to collect revenue rather than to stimulate business and other "socially beneficial" activities. Well, the Treasury tax simplification plan does just that. It proposes to extract the government from the economy in a way that goes far beyond any prior national policies to date.

While I am in favor of tax simplification and an economic neutral and equitable system, I am concerned about the impact the Treasury proposal would have on the economic viability of our nation, particularly the capital intensive manufacturing sector. Yes, I have read the economic studies which originally opposed the proposal as having an adverse impact on the growth, productivity and competitiveness of manufacturing industries. And yes, I am aware that these opponents have changed their initial views, now saying that lower corporate tax rates, index depreciation, and better treatment of dividends and capital gains would more than offset the elimination of the "boogie-men" subsidies of the ACRS and the ITC.

Despite this, the critics of the Treasury proposal ask the same question that I now ask: "Can the economy go cold turkey?" Every Member of this Subcommittee, in fact, every Member of Congress recognizes that while our economy is on a locomotive recovery, its competitiveness still remains vulnerable to the effects of the overvalued dollar, the budget deficit, and the competitive incentives accorded to their international competitors by their respective governments.

I am concerned that the immediate effects of the Treasury proposal will stifle capital investment which, in turn, will stymie growth, modernization and, ultimately long-term competitiveness. The analyses of the critics, and now proponents of the Treasury plan, support my concern. They all agree that investment will be treated more harshly and will result in a loss in near-term economic output and a long-term decline in capital development. Further, they still question whether the current economic climate is an appropriate one in which to introduce such a set of changes. They could not have conveyed my sentiments any better.

I hope that these issues will be discussed fully during this hearing. Yes, tax simplification is a desire for all of us. But not at the expense of our economic future, and, in particular, not at the expense of our manufacturing sector, which has been the engine of our economy since the beginning of this nation.

HARRIS
BANK
Chicago, Illinois

Harris
Economics.

January 4, 1985

THE IMPACT OF TAX REFORM ON THE U.S. ECONOMY

by Robert J. Genetski, Debra J. Bredael and Brian S. Wesbury

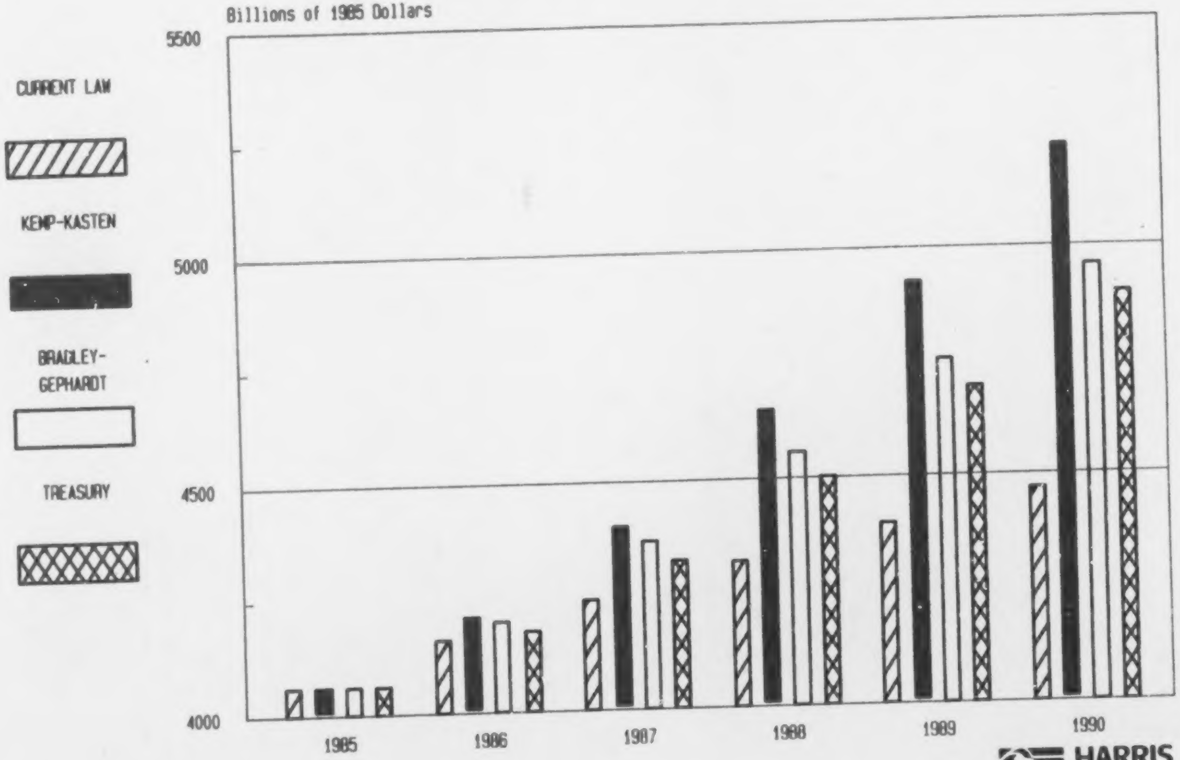
The introduction of several tax reform proposals is the result of a continuing trend away from the highly taxed, less productive economy of the 1970s. By 1990 the leading tax reform proposals would enable the economy to produce anywhere from $430 to $750 billion (1985 dollars) more output than under the present system. The present system contains hidden increases in tax rates when real income gains push individuals into higher tax brackets. Without reform these increases could cause the underlying productivity trend to slow by as much as 1 1/2 percent per year.

Of the major reform proposals, the best overall performance occurs under the Kemp-Kasten plan where a sharp reduction in tax rates helps to restore incentives for growth. Higher productivity gains produce lower inflation and push mortgage rates down to 7 3/4 percent. In this environment there is a strong inclination to follow a steady monetary policy. As a result, economic stability is attained.

Under the Bradley-Gephardt tax proposal, the economy experiences an initial period of rapid growth. However, the failure to index the tax system for inflation means that taxpayers are pushed into higher tax brackets when inflation occurs. This arrangement gives politicians a strong incentive to inflate the economy whenever they need more revenues. As a result, Bradley-Gephardt is likely to lead to more inflation and higher interest rates than either the Kemp-Kasten or Treasury proposals.

Of the three leading tax reform proposals the Treasury's is the worst, at least in the short-run. Although tax rates are lower than under present law, the top rates are considerably higher than either of the alternative proposals. More important, the Treasury plan complicates the tax system more than ever. An abrupt change in the tax treatment of certain items results in fairly dramatic and somewhat arbitrary changes in asset values. These changes can lead to a disruption in the economic process. Also, the advantage of lower rates for individuals is partially offset by increasing the corporate tax burden. Since corporations do not pay taxes but merely collect them, individual tax rates appear lower than they actually are. All these factors lead to a disappointing performance for the economy in 1986 if the Treasury plan is enacted. The longer-term impact of the Treasury proposal may be more promising than its short-term effect.

TAX REFORM and POTENTIAL REAL OUTPUT



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The Impact of Tax Reform on Potential Output

The best indication of the success or failure of any of the tax proposals is its impact on the economy's potential output. An economy's potential is the maximum, sustainable real output it can produce without straining its capacity. Gains in potential real output are constrained by labor force growth, the average workweek and most importantly, by gains in productivity. Indirectly, potential output can provide a good measure of potential living standards.

Current Law

The built-in tax increase under present law slows underlying productivity growth to 1/2 percent per year by 1990. As a result, the growth in potential output slows substantially from the current trend.

Kemp-Kasten

Implementing the K-K provisions leads to an additional $750 billion (1985 dollars) of potential output in 1990 over what would be the case under present law. The difference represents more than $5,000 of additional real income per worker in 1990. Beyond 1990 the effect of compounding results in even more dramatic gains.

Bradley-Gephardt

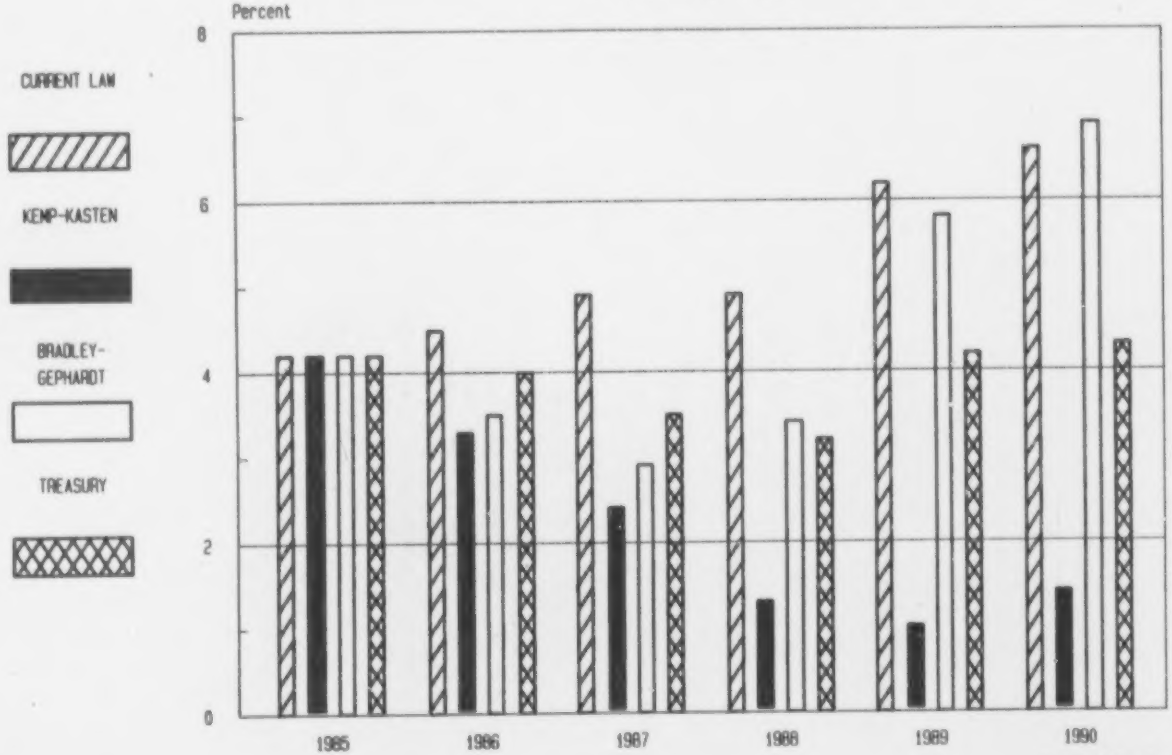
An additional $490 billion (1985 dollars) of output would be created under the B-G proposals. Higher inflation and the accompanying increase in effective marginal tax rates serves to limit productivity gains in the out years.

Treasury

The delay in implementing some tax cuts along with the disruption created by a new and complex tax proposal results in a slow start. By 1990 the economy has adjusted to many of the temporary problems and is able to produce $430 billion (1985 dollars) more than under the existing tax structure. Since the Treasury plan indexes the tax system for inflation, tax rates do not increase as they do under the B-G proposal. As a result, potential output under the Treasury plan will eventually be greater than under B-G.

TAX REFORM and INFLATION

(IMPLICIT PRICE DEFLATOR)



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The Impact of Tax Reform on Inflation

Although inflation is primarily a monetary phenomenon, it is also affected by productivity growth. Strong productivity performance means that a greater proportion of spending will be reflected in real growth and less in inflation. Also, the stronger the advance in productivity, the less likely it is that there will be pressure for an inflationary monetary policy.

Current Law

Rising effective tax rates lead to slower productivity, political pressures for more stimulus and higher inflation. By 1990 inflation is close to 6 to 7 percent and being held in check by a recession. However, as in the late 1970s, the underlying inflationary trend is up.

Kemp-Kasten

Strong productivity growth and a flat tax rate combine to encourage long-term price stability. Although the money supply grows at a rate of 6 percent per year, a strong boost in potential output enables practically all of the increase in spending to take the form of real growth instead of inflation.

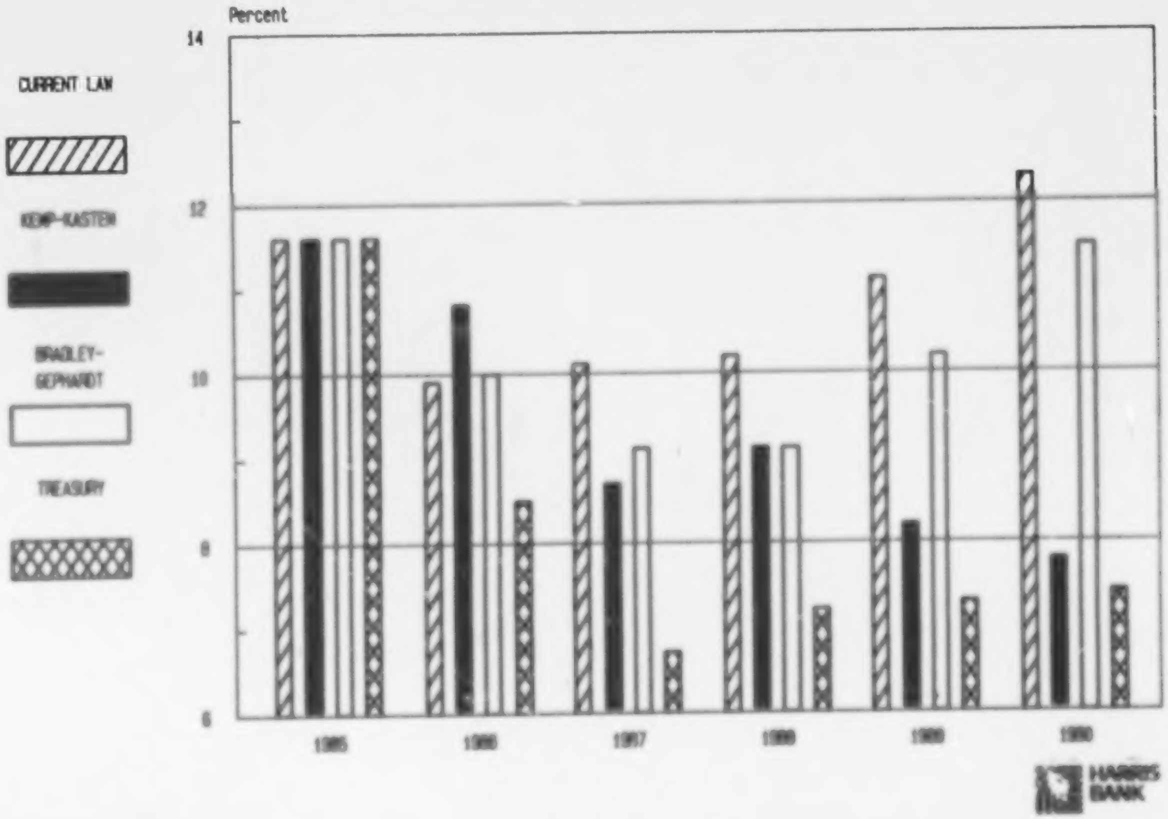
Bradley-Gephardt

Although a rapid increase in potential output initially holds inflation in check, the political urge to raise revenues through inflation is satisfied. As a result, inflation jumps to 7 percent by 1990.

Treasury

The dislocations produced by the Treasury plan will create pressure for higher inflation. However, as a result of double indexing (the Treasury plan indexes tax brackets as well as the inflation component of interest rates) the government may actually lose revenues as inflation moves higher. These two factors are assumed to work against each other and inflation remains in the 4 to 5 percent vicinity.

TAX REFORM AND MORTGAGE RATES



The Impact of Tax Reform on Interest Rates

Interest rates are the result of a complex set of economic forces. These forces can act upon either the real after-tax interest rate, the inflationary premium or the tax premium. As inflation and marginal tax rates increase, they tend to raise the inflation and tax portions of interest rates. The real after-tax portion of the interest rate is influenced over the short-term by shifts in monetary policy and over the long-term by productivity performance. As the productivity trend increases, so does the nation's return on investment and the real after-tax portion of the interest rate.

Current Law

Higher inflation and higher effective tax rates result in high and rising interest rates. By 1990 Treasury bill rates average 11 percent, the prime 13 1/2 percent and mortgage rates 12 1/4 percent.

Kemp-Kasten

The lowest inflation and tax rates of any plan provide for the greatest decline in interest rates under K-K. However, part of the decline is moderated by the boost in productivity. Greater productivity means that businesses are both willing and able to pay higher real after-tax interest rates. In spite of this offset, by 1990 Treasury bill rates decline to approximately 5 percent, the prime rate is 7 1/2 percent and fixed 30-year mortgage rates drop to 7 3/4 percent.

Bradley-Gephardt

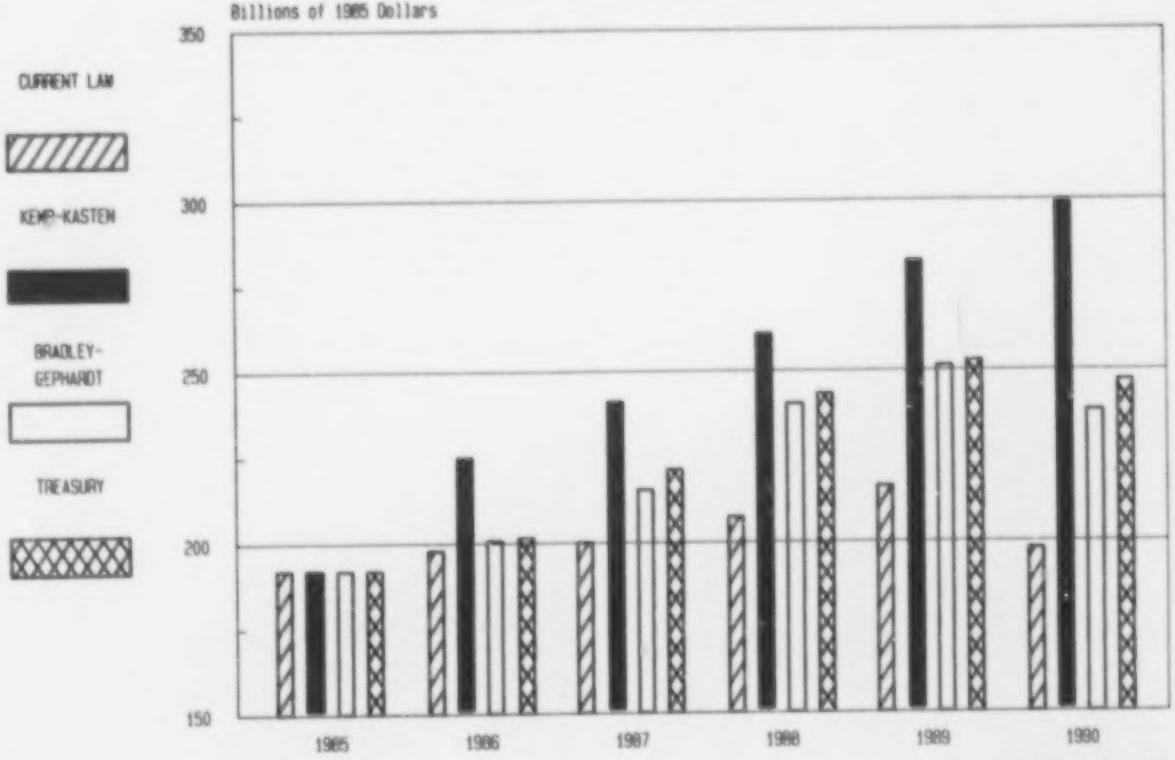
Initially interest rates are similar to those attained under Kemp-Kasten. Eventually, higher inflation and a more erratic monetary policy lead to higher, more volatile rates. By 1990 Treasury bill rates are 11 1/2 percent, the prime 14 percent and mortgage rates 11 1/2 percent.

Treasury

Although inflation is slightly higher under this plan than under Kemp-Kasten, interest rates initially are lower. One reason for this result is that the slower productivity trend under the Treasury plan results in lower real after-tax rates. Another reason is related to the reduction in tax rates on interest income as inflation rises. Treasury bill rates, which drop to 4 percent in 1987 rise to 5 1/2 percent by 1990. In 1990 the prime averages 8 percent and mortgage rates are approximately 7 1/2 percent.

TAX REFORM and CORPORATE PROFITS

(AFTER-TAX ADJUSTED PROFITS)



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The Impact of Tax Reform on Corporate Profits

The alternative tax proposals affect the profit figures in dramatically different ways. When depreciation schedules are lengthened, as under the Treasury and Bradley-Gephardt plans, reported profits register an increase. The main effect of this increase is to boost corporate tax liabilities. Also, different inflation rates will distort the real profitability of corporations. As a result, the best measure for comparing the impact of the tax plans on corporate income is the behavior of real after-tax profits adjusted for depreciation and inventory profits.

Current Law

Under the current tax system real corporate profits adjusted for depreciation and inventory profits show little gain. The combination of rising inflation, higher interest rates and slower productivity represents a replay of the forces that contributed to poor profitability during the 1970s.

Kemp-Kasten

The proposal with the lowest tax rates, lowest inflation, lowest interest rates and largest productivity gains provides for the largest gain in real profits. By 1990, real profits are 50 percent higher than under present law.

Bradley-Gephardt

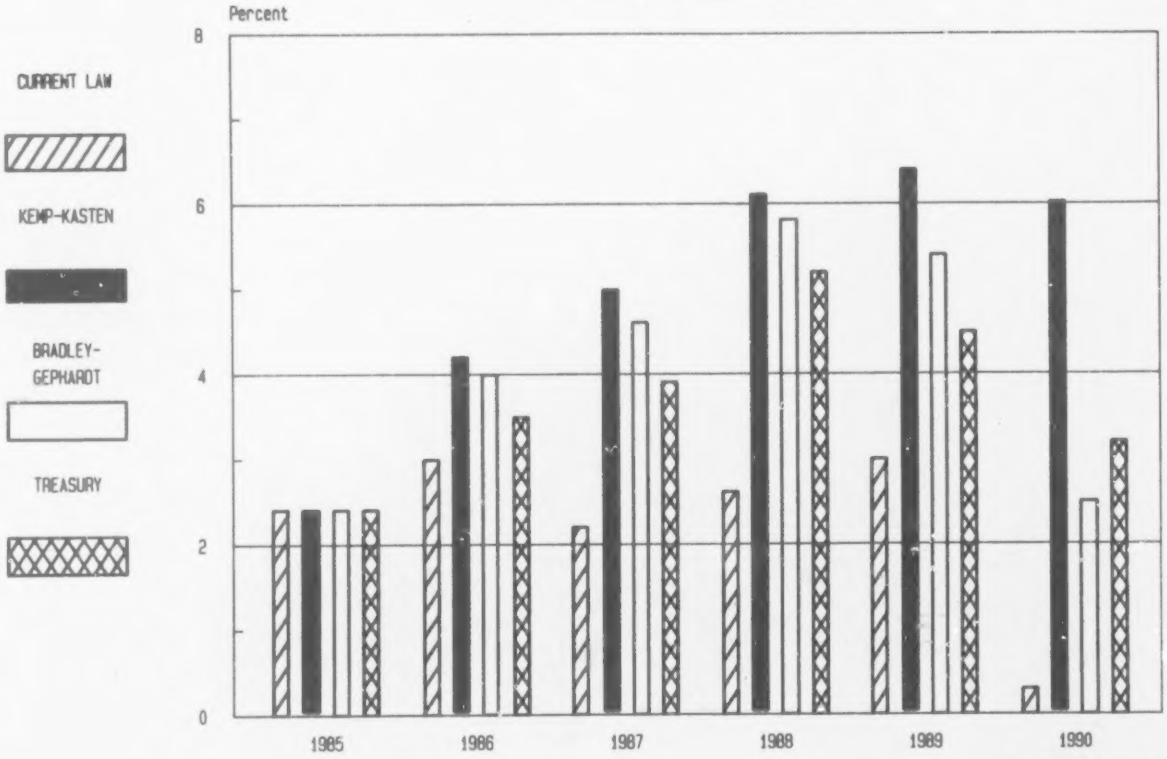
The increase in productivity provides the impetus for substantial gains in real profits under the B-G proposal. Although the corporate tax rate is 30 percent, the same as under K-K, longer depreciation schedules, rising inflation and higher interest rates begin to take their toll on real profits by the end of the decade.

Treasury

In spite of a corporate tax rate of 33 percent, real profits under the Treasury plan are slightly better than under B-G. This is due to the Treasury's grandfathering of prior depreciation schedules. By the end of the decade the Treasury and B-G depreciation schedules have a similar impact on reported profits. However, for the Treasury plan, lower inflation, lower interest rates and stronger productivity produce real after-tax profits that are 25 percent higher than under current law.

TAX REFORM and ECONOMIC STABILITY

(YEAR over YEAR CHANGES IN REAL GNP)



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The Impact of Tax Reform on Economic Stability

The timing or nature of a business cycle is highly speculative regardless of the tax structure. However, as a general rule, the more conducive the tax structure is to growth, the greater the likelihood of avoiding cyclical swings.

Current Plan

Slower productivity creates a vicious circle for monetary policy. Pressures to increase growth encourage expansive monetary policy and lead to higher inflation. The higher inflation numbers induce monetary tightening and, by 1990, a recession. The timing of a recession in 1990 is fairly arbitrary. Should monetary policy continue to prop up the economy, the recession could be postponed. However, this would mean more inflation and higher interest rates than now expected for 1990. In contrast, monetary policy could be geared toward avoiding the jump in inflation and interest rates depicted in these simulations. Unfortunately, with current tax legislation this could only be accomplished with a much slower pace of real growth than presently shown.

Kemp-Kasten

The greatest reduction in tax rates leads to the strongest, most sustainable increase in output. It would take a severe mistake in monetary policy before the economy would slow to even a 3 percent rate of real growth. As a result, this proposal provides the best opportunity for economic stability.

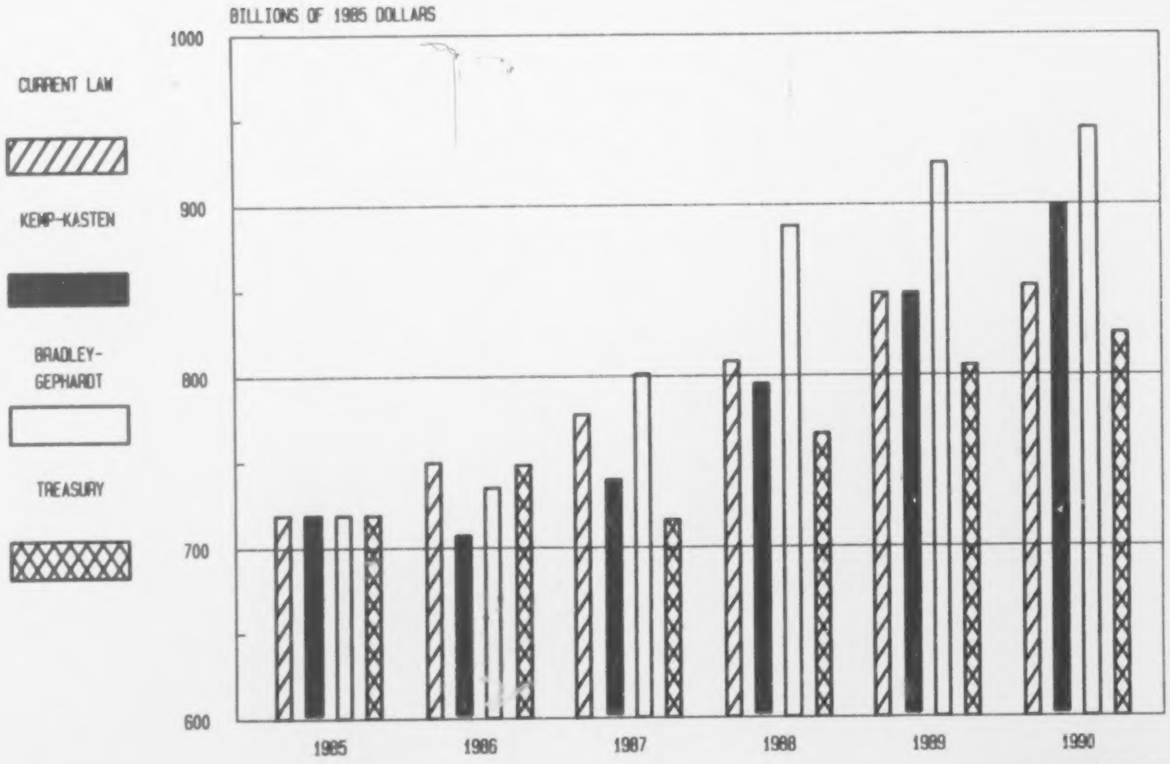
Bradley-Gephardt

Based on income affected, this proposal provides for a substantial cut in effective tax rates for 1986. However, the failure to index the system eventually leads to faster money growth, higher inflation, a gradual increase in effective tax rates and a return to cyclical pressures.

Treasury

The disruptive effects of wholesale changes in the philosophy of the tax system lead to an initial setback for the economy. Once a new army of lawyers and accountants figures out what the changes mean, and once asset values have adjusted to the new environment, real growth can resume at a faster, more stable pace.

TAX REFORM and REAL GOVERNMENT REVENUES



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The Impact of Tax Reform on Federal Budget Revenues

Most recent studies of the effects of tax reform on revenues and outlays are static. They assume no changes in the overall level of economic activity, inflation or interest rates as a result of tax reform. The Harris model of the federal budget incorporates the dynamic chances associated with each tax proposal. Since the effects of tax changes on economic growth, interest rates and inflation on the budget are dramatic, simulations that ignore them are misleading.

Many insist that a key objective in designing tax reform should be revenue neutrality. However, such a concept has little meaning in dynamic simulations. Lowering tax rates initially decreases revenues. However, by increasing productivity, real government revenues eventually will be greater. Giving up revenue today for more tomorrow is an integral part of the economic process. By viewing the behavior of real government revenues under the alternative tax proposals, the importance of a dynamic simulation becomes self-evident.

Current Law

Real revenues (1985 dollars) increase at 3.5 to 4 percent annually through 1989 but slow dramatically in 1990 due to a recession. Federal revenue continues to usurp a larger and growing part of GNP climbing from 18.6 percent in 1984 to 19.8 percent of the GNP by 1990.

Kemp-Kasten

Under K-K revenues are lower for three years, but then, as growth picks up so do revenues. By 1990 real government revenues are increasing at a 6 percent rate. By promoting strong growth K-K allows the government to receive close to $50 billion (1985 dollars) more in real receipts by 1990 with lower tax rates. In spite of these gains revenues fall to 18 percent of a substantially larger GNP.

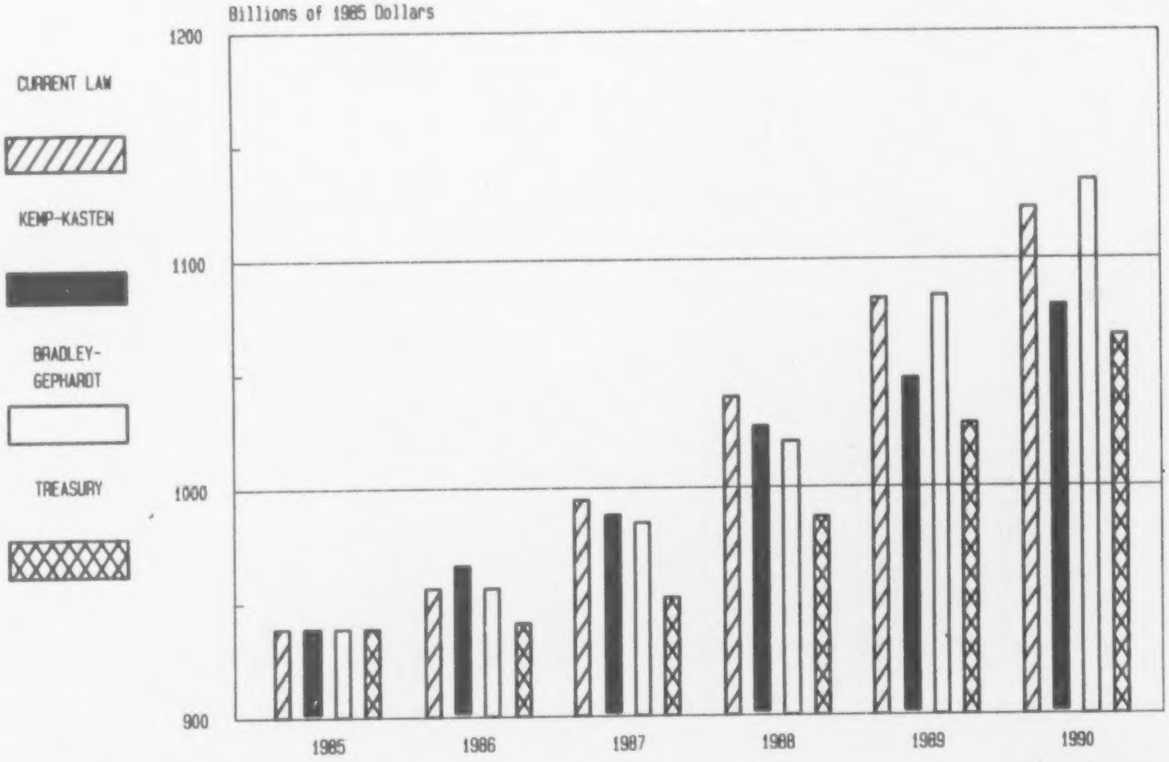
Bradley-Gephardt

The highest real revenues of any of the proposals occurs under the B-G plan. Government revenues initially benefit from strong economic growth and subsequently from inflation-induced increases in tax rates.

Treasury

The Treasury proposal is revenue neutral in 1986 only because it delays implementation of the individual tax cut until July. Thereafter real revenues fall and by 1990 are significantly lower than under any of the other proposals.

TAX REFORM and REAL GOV'T OUTLAYS



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The Impact of Tax Reform on Federal Budget Outlays

Analysis of federal government outlays in the Harris model is accomplished under the assumption that current spending patterns remain unchanged. The only real component that is allowed to fluctuate is net interest. All other spending is adjusted only for changes in inflation rates. Net interest expense for the government is a significant item. In 1986 a 1 percent increase or decrease in interest rates can add or subtract $18 billion from total outlays. By 1990 this expense can be compounded by additional deficits and may amount to as much as $87 billion.

Current Law

Net interest payments average an annual growth rate of over 13 percent between 1985 and 1990. After adjustment for inflation total real outlays rise 3 1/2 to 4 1/2 percent annually. By 1990 outlays grow to 26 percent of GNP.

Kemp-Kasten

Real outlays rise at an annual rate of less than 3 percent per year between 1985 and 1990 as inflation and interest rates drop considerably. This allows outlays as a percent of GNP to fall to 21.5 percent in 1990 while maintaining all federal programs as presently planned.

Bradley-Gephardt

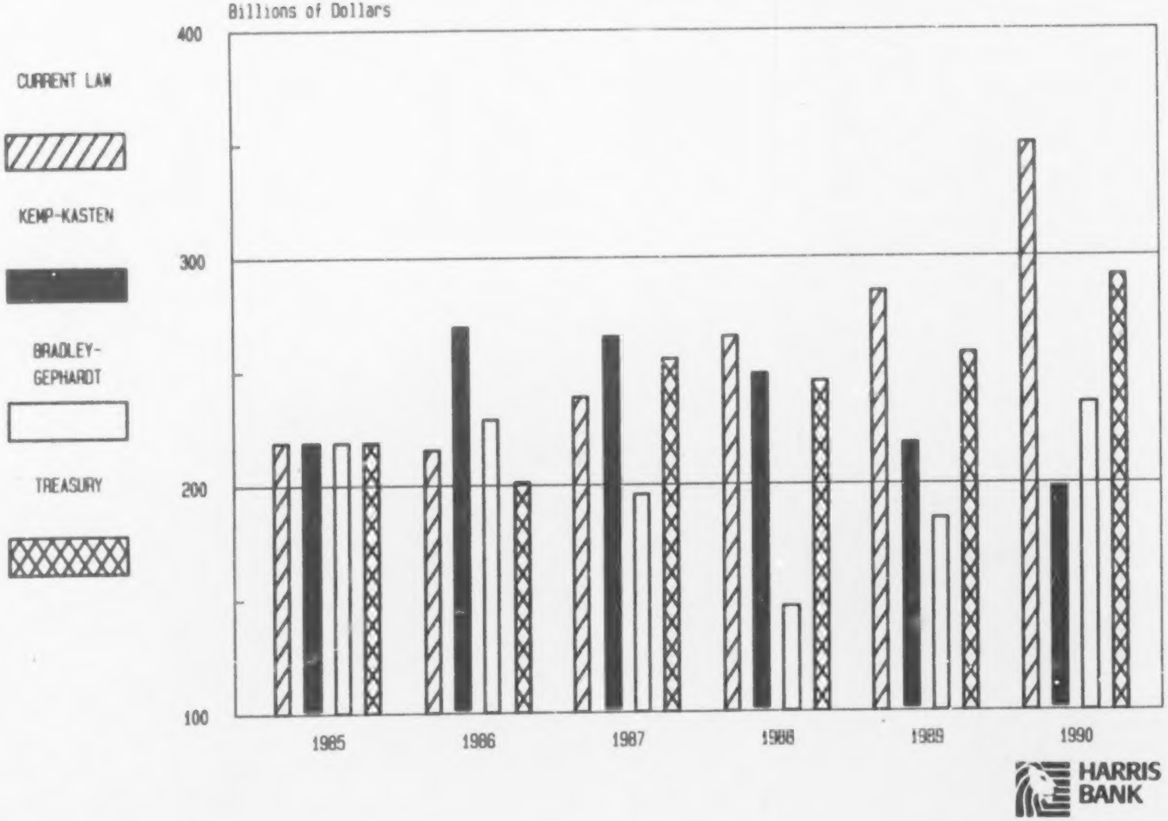
With increasing interest rates in the out years B-G has the highest real government outlays. Even so, the improvement in economic growth results in government outlays of less than 24 percent of GNP.

Treasury

The Treasury proposal has the lowest real government outlays. This results from a combination of lower deficits (at least initially) and lower interest rates.

TAX REFORM and BUDGET DEFICITS

(ACTUAL DOLLAR DEFICITS)



The Impact of Tax Reform on Federal Budget Deficits

Deficits are the result of government spending patterns and tax policies. In this analysis government programs are assumed to remain unchanged, so that any changes in the relative size of the federal budget deficit result solely from tax changes and the resulting effects of a tax change on inflation, interest rates and real growth.

Current Law

The explosive growth in net interest outlays combined with a recession in 1990 produces a current dollar deficit of $350 billion per year by the end of the decade. As a percent of GNP the deficit rises from 4.9 percent in 1984 to 6 percent in 1990.

Kemp-Kasten

After peaking at $269 billion in 1986 the deficit falls to $199 billion in 1990. This scenario brings the deficit to 3 1/2 percent of GNP. By 1990 receipts are rising faster than outlays. By extending the 1990 trends produces a balanced budget in 1998 with no changes in current government programs.

Bradley-Gephardt

By 1990 the deficit approaches $240 billion, representing 4 percent of GNP. After initially falling to $146 billion in 1988, slower growth and higher interest rates serve to increase the deficit.

Treasury

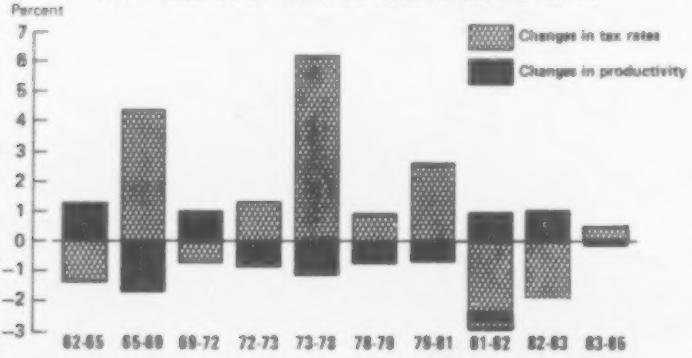
Low interest rates hold outlays to a relatively slow growth path, but with languishing receipts, deficits continue to grow. By 1990 the Treasury plan has a deficit of $291 billion which is 5.1 percent of GNP. As with B-G, without changes in spending patterns the Treasury plan would not alleviate the political pressures associated with large budget deficits.

Impact of Tax Rates on Economic Activity

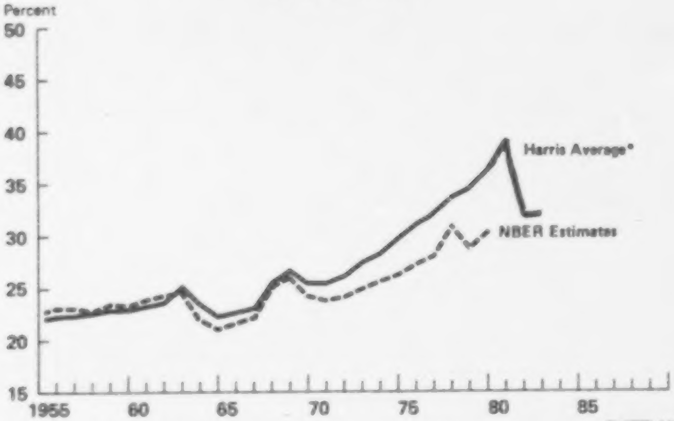
Until recently the impact of individual tax rates on long-term productivity performance was largely ignored in the economic literature. The key problem in studying the issue was the lack of a good series on effective marginal tax rates. These are the tax rates actually paid on the additional income of particular individuals. The first attempt to produce a useful series on effective tax rates was developed at the Harris Bank in 1981. This was followed in 1983 when two researchers at the National Bureau of Economic Research produced alternative estimates. Both series show the same general pattern for the behavior of effective marginal tax rates from 1955-80. The present report uses the Harris series as a basis for effective marginal tax rates since it focuses on those rates affecting individuals who control large sums of potential savings. Also, the Harris series contains more timely information. This series was first used in 1981 to evaluate the Kemp-Roth proposal to cut tax rates by 30 percent. Based on the prior inverse relationship between changes in effective tax rates and changes in the economy's underlying productivity trend, the 1981 analysis predicted a substantial improvement in the economy's productivity trend as a result of the 1981 tax cuts. Subsequent analysis tends to confirm that such an increase has occurred.

In the spring of 1984, the relationship between tax rates and productivity was updated. The updated analysis indicated that for the past three decades every positive move in the economy's underlying productivity trend occurred at the same time that effective marginal tax rates were being reduced. Also, each time the economy's underlying productivity trend has deteriorated, effective marginal tax rates were being increased. The following charts summarize these findings.

CHANGES IN TAX RATES AND PRODUCTIVITY



Tax changes are differences in effective marginal rates from beginning to end of period.
Productivity changes are differences in the annualized structural trend from the previous period.
* - Estimated changes in tax rates and productivity trend based on 1984 tax structure.
Source: Bureau of Labor Statistics; Harris Bank.



MARGINAL PERSONAL TAX RATES

Harris vs. NBER

*Average of the 70th percentile and the 95th percentile of taxable returns.
Source: National Bureau of Economic Research; Harris Bank

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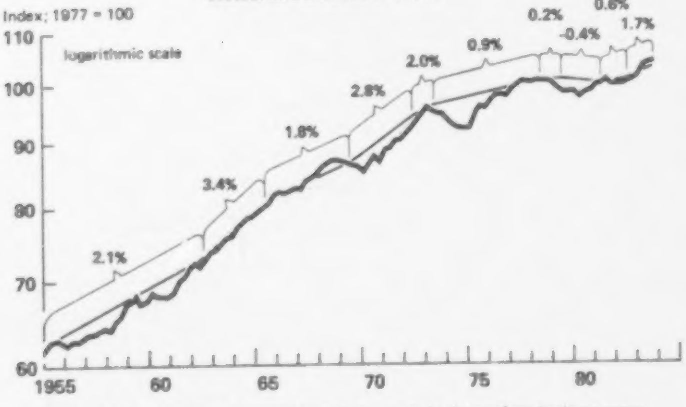


PRODUCTIVITY

Actual and Structural Trend

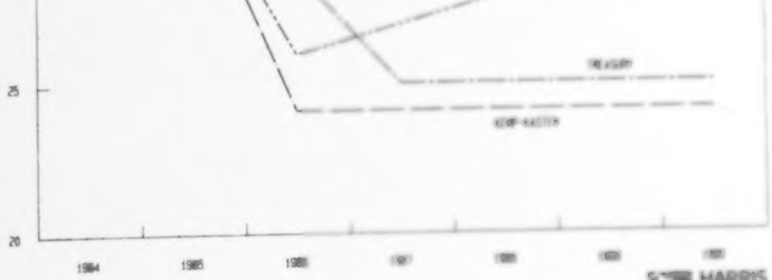
Productivity defined as output per hour of all persons in the nonfarm business sector.
Brackets show long-term growth trends
Source: Bureau of Labor Statistics; Harris Bank

Some skepticism is often expressed over the possibility that tax changes can have either so powerful or so instantaneous an effect on the underlying productivity trend. While tax changes can impact productivity in many ways, one important avenue is the effect they have on the efficient use of savings. In a market economy savings (resources used for future production) tend to be allocated toward their most productive use. However, under the present tax system, as effective tax rates increase, so do incentives to retain more income. These incentives lead households to shift resources into those areas that provide the highest after-tax return as opposed to those areas that might utilize the resources most efficiently. Redirecting even a relatively small amount of resources from their most efficient use can have a significant effect on the economy's overall efficiency. As for the seemingly instantaneous response to tax changes, it is noteworthy that by the time most tax changes occur their impact has long since been anticipated. Although the tax cuts that went into effect in 1982 and 1983 seemed to result in an immediate positive move in the long-term productivity trend, the specifics of the cut were well-known in the summer of 1981.

Assumptions and Qualifications

An analysis of past changes in productivity trends reveals that changes in effective marginal tax rates may be the single most important factor affecting these trends. The effective marginal tax rate series in this historical analysis focuses on the tax rates paid by individuals with control over large sums of potential saving. These individuals are assumed to be centered around the 80th to 85th percentile of all households, and for 1985 have an adjusted gross income of approximately $40,000. For 1986-1990 effective marginal tax rates are calculated for this group under the present tax system and for each of the major alternative tax proposals. These rates are shown in the following chart.

EFFECTIVE MARGINAL TAX RATES



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On average, for the period 1955-1983 a one percentage point change in effective marginal tax rates has been associated with a change in productivity growth of three-tenths of a percentage point in the opposite direction. This relationship was used as the basis for adjusting the productivity trend for the impact of the alternative tax plans.

Still, much is unknown about the precise impact of changes in taxes and the structure of the tax system on productivity. In assessing the impact of the alternative plans, information from past experience and adjustments deduced from economic theory were combined to adjust productivity growth. These "ad hoc" adjustments may work to present any of the alternative tax proposals in a somewhat more or less favorable light than might actually be the case. For example, a constraint limiting a one-year shift in the productivity trend serves to dampen the initial response in productivity to the K-K and B-G proposals. Also, the assumption that the distortions and complexity in the Treasury proposals will result in slower productivity may discriminate against the Treasury proposal. However, if the cost of the proposal is even greater than assumed, then the benefits from the Treasury proposal have been overstated. In addition, a fairly modest adjustment to productivity was made for the effect of the higher maximum rates in the B-G and Treasury proposals. To the extent that the top marginal rate has a greater influence on efficiency, our results present the B-G and Treasury proposals in a more favorable light than they deserve. In making each of the adjustments where the evidence provides little or no guidance, our overwhelming concern was to depict the most likely economic response to the particular proposals rather than to endorse or criticize any of the plans.

Consequently, the complexity of the Treasury proposal and its need for diverting more of the economy's resources toward tax lawyers and accountants was assumed to reduce productivity growth by 0.5 percent per year. The temporary dislocations from the present system were assumed to lower productivity trend by 0.1, 0.25 and 0.5 percent for the K-K, B-G, and Treasury plans respectively. In addition, the alternative maximum tax rates and the assumed shift in the tax burden from individuals to corporations were assumed to have some minor negative impact on productivity in both the B-G and Treasury plans.

12/21/84

CURRENT LAW

LONG-TERM ECONOMIC OUTLOOK

	1983	1984	1985	1986	1987	1988	1989	1990
MARGINAL TAX RATE	.318	.317	.321	.326	.330	.334	.341	.343
MONEY SUPPLY-(M1)	509.1	542.4	575.0	608.8	641.5	689.6	736.4	781.5
%ch	11.0	6.5	6.0	5.9	5.4	7.5	6.8	6.1
GROSS NATL PRODUCT	3304.8	3660.9	3905.0	4203.2	4505.1	4850.3	5301.2	5669.7
%ch	7.7	10.8	6.7	7.6	7.2	7.7	9.3	7.0
REAL GNP	1534.7	1637.5	1676.9	1727.0	1764.4	1810.7	1864.6	1869.8
%ch	3.7	6.7	2.4	3.0	2.2	2.6	3.0	.3
GNP DEFLATOR	2.1534	2.2355	2.3284	2.4336	2.5532	2.6782	2.8430	3.0320
%ch	3.8	3.8	4.2	4.5	4.9	4.9	6.2	6.6
CPI-ALL URBAN	2.983	3.110	3.238	3.383	3.548	3.720	3.947	4.208
%ch	3.2	4.3	4.1	4.5	4.9	4.9	6.1	6.6
PRETAX PROFITS	203.2	235.1	238.9	266.2	285.1	319.5	372.5	371.8
%ch	22.8	15.7	1.6	11.4	7.1	12.1	16.6	-.2
PRETAX PROFITS ADJ 1)	225.2	283.1	284.6	311.6	334.5	373.8	429.2	430.2
%ch	41.5	25.7	.5	9.5	7.4	11.7	14.8	.2
AFTER TAX PROFITS	127.4	145.4	146.0	161.2	169.5	184.1	207.3	199.4
%ch	21.6	14.1	.4	10.5	5.1	8.6	12.6	-3.8
AFTER TAX PROFITS ADJ 1)	149.4	193.4	191.6	206.6	219.0	238.4	264.0	257.8
%ch	51.8	29.4	-.9	7.8	6.0	8.8	10.7	-2.3
PRODUCTIVITY	1.034	1.062	1.077	1.094	1.104	1.117	1.131	1.127
%ch	3.4	2.7	1.4	1.6	.9	1.2	1.2	-.3
EMPLOYMENT-CIVILIAN	100.8	105.0	107.0	109.2	110.9	112.7	115.1	115.7
%ch	1.3	4.1	1.9	2.1	1.6	1.6	2.1	.5
UNEMPLOYMENT RATE	9.6	7.5	7.2	6.8	6.9	6.8	6.3	7.2
POTENTIAL REAL GNP	1644.4	1693.8	1744.7	1786.0	1821.7	1855.3	1888.3	1918.8
%ch	3.0	3.0	3.0	2.4	2.0	1.8	1.8	1.6
REAL GNP % POTENTIAL REAL GNP	.9306	.9667	.9611	.9669	.9685	.9759	.9874	.9744
INTEREST RATES								
NEW ISSUE AA INDUS BONDS	12.2	13.2	11.1	9.4	9.6	9.7	10.6	11.8
NEW ISSUE AA UTIL BONDS	12.6	13.6	11.5	9.8	10.0	10.1	11.0	12.1
30-YR GOVT SECURITIES	11.2	12.4	10.4	8.7	8.9	9.0	9.9	11.1
10-YR GOVT SECURITIES	11.1	12.4	10.3	8.6	8.8	8.9	9.8	11.0
PRIME RATE	10.8	12.0	10.4	9.8	10.5	10.2	12.5	13.4
90-DAY CDS	9.1	10.4	8.6	8.3	9.0	8.7	10.9	11.8
6-MONTH COMMERCIAL PAPR	8.9	10.1	8.4	8.1	8.8	8.5	10.7	11.6
3-MONTH T-BILL	8.6	9.5	7.9	7.5	8.2	7.9	10.0	11.0

1)PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST.

12/21/84

KEMP-KASTEN

LONG-TERM ECONOMIC OUTLOOK

	1983	1984	1985	1986	1987	1988	1989	1990
MARGINAL TAX RATE	.318	.317	.321	.241	.241	.241	.241	.241
MONEY SUPPLY-(M1)	509.1	542.4	575.0	608.8	645.3	684.0	725.1	768.6
%ch	11.0	6.5	6.0	5.9	6.0	6.0	6.0	6.0
GROSS NATL PRODUCT	3304.8	3660.9	3905.0	4203.2	4517.1	4855.9	5220.1	5611.6
%ch	7.7	10.8	6.7	7.6	7.5	7.5	7.5	7.5
REAL GNP	1534.7	1637.5	1676.9	1746.9	1834.2	1945.8	2070.5	2195.1
%ch	3.7	6.7	2.4	4.2	5.0	6.1	6.4	6.0
GNP DEFLATOR	2.1534	2.2355	2.3284	2.4058	2.4626	2.4954	2.5210	2.5563
%ch	3.8	3.8	4.2	3.3	2.4	1.3	1.0	1.4
CPI-ALL URBAN	2.983	3.110	3.238	3.344	3.421	3.464	3.497	3.546
%ch	3.2	4.3	4.1	3.3	2.3	1.3	1.0	1.4
PRETAX PROFITS	203.2	235.1	238.9	266.6	288.2	313.0	342.7	371.9
%ch	22.8	15.7	1.6	11.6	8.1	8.6	9.5	8.5
PRETAX PROFITS ADJ 1)	225.2	283.1	284.6	312.6	341.5	373.7	408.0	440.0
%ch	41.5	25.7	.5	9.9	9.2	9.4	9.2	7.8
AFTER TAX PROFITS	127.4	145.4	146.0	186.6	201.8	219.1	239.9	260.4
%ch	21.6	14.1	.4	27.8	8.1	8.6	9.5	8.5
AFTER TAX PROFITS ADJ 1)	149.4	193.4	191.6	232.7	253.1	279.8	305.2	328.4
%ch	51.8	29.4	-.9	21.4	9.6	9.7	9.1	7.6
PRODUCTIVITY	1.034	1.062	1.077	1.107	1.147	1.202	1.262	1.323
%ch	3.4	2.7	1.4	2.8	3.6	4.8	5.0	4.9
EMPLOYMENT-CIVILIAN	100.8	105.0	107.0	109.6	111.9	114.1	116.4	118.7
%ch	1.3	4.1	1.9	2.4	2.1	2.0	2.0	2.0
UNEMPLOYMENT RATE	9.6	7.5	7.2	6.5	6.1	5.7	5.2	4.7
POTENTIAL REAL GNP	1644.4	1693.8	1744.7	1806.8	1889.7	1996.1	2115.8	2242.8
%ch	3.0	3.0	3.0	3.6	4.6	5.6	6.0	6.0
REAL GNP % POTENTIAL REAL GNP	.9386	.9667	.9611	.9668	.9705	.9748	.9785	.9787
INTEREST RATES								
NEW ISSUE AA INDUS BONDS	12.2	13.2	11.1	10.3	8.2	8.6	7.7	7.2
NEW ISSUE AA UTIL BONDS	12.6	13.6	11.5	10.7	8.6	9.0	8.1	7.7
30-YR GOVT SECURITIES	11.2	12.4	10.4	9.6	7.5	7.9	7.0	[illegible]
10-YR GOVT SECURITIES	11.1	12.4	10.3	9.5	7.4	7.8	6.9	6.5
PRIME RATE	10.8	12.0	10.4	9.9	7.4	7.4	7.0	7.5
90-DAY CDS	9.1	10.4	8.6	8.4	5.9	5.9	5.5	6.0
6-MONTH COMMERCIAL PAPR	8.9	10.1	8.4	8.2	5.7	5.7	5.3	5.8
3-MONTH T-BILL	8.6	9.5	7.9	7.6	5.1	5.1	4.7	5.2

1)PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST.

12/21/84

BRADLEY-GEPHARDT

LONG-TERM ECONOMIC OUTLOOK

	1983	1984	1985	1986	1987	1988	1989	1990
MARGINAL TAX RATE	.318	.317	.321	.260	.270	.280	.280	.280
MONEY SUPPLY-(M1)	509.1	542.4	575.0	608.8	647.8	709.2	773.7	835.6
%ch	11.0	6.5	6.0	5.9	6.4	9.5	9.1	8.0
GROSS NATL PRODUCT	3304.8	3660.9	3905.0	4203.2	4523.8	4952.7	5522.6	6052.1
%ch	7.7	10.8	6.7	7.6	7.6	9.5	11.5	9.6
REAL GNP	1534.7	1637.5	1676.9	1743.8	1823.5	1930.0	2033.9	2084.9
%ch	3.7	6.7	2.4	4.0	4.6	5.8	5.4	2.5
GNP DEFLATOR	2.1534	2.2355	2.3284	2.4101	2.4806	2.5656	2.7149	2.9025
%ch	3.8	3.8	4.2	3.5	2.9	3.4	5.8	6.9
CPI-ALL URBAN	2.983	3.110	3.238	3.349	3.445	3.562	3.767	4.026
%ch	3.2	4.3	4.1	3.4	2.9	3.4	5.8	6.9
PRETAX PROFITS	203.2	235.1	238.9	348.9	380.5	431.1	474.4	480.9
%ch	22.8	15.7	1.6	46.1	9.1	13.3	10.0	1.4
PRETAX PROFITS ADJ 1)	225.2	283.1	284.6	312.7	343.5	393.7	435.0	441.4
%ch	41.5	25.7	.5	9.9	9.9	14.6	10.5	1.5
AFTER TAX PROFITS	127.4	145.4	146.0	244.2	266.4	301.8	332.1	336.6
%ch	21.6	14.1	.4	67.3	9.1	13.3	10.0	1.4
AFTER TAX PROFITS ADJ 1)	149.4	193.4	191.6	208.0	229.3	264.4	292.7	297.1
%ch	51.8	29.4	-.9	8.5	10.3	15.3	10.7	1.5
PRODUCTIVITY	1.034	1.062	1.077	1.105	1.141	1.186	1.230	1.257
%ch	3.4	2.7	1.4	2.6	3.2	4.0	3.7	2.2
EMPLOYMENT-CIVILIAN	100.8	105.0	107.0	109.4	111.6	114.1	116.5	118.6
%ch	1.3	4.1	1.9	2.2	2.0	2.3	2.1	1.8
UNEMPLOYMENT RATE	9.6	7.5	7.2	6.7	6.3	5.6	5.1	4.8
POTENTIAL REAL GNP	1644.4	1693.8	1744.7	1803.5	1876.4	1957.0	2041.2	2129.0
%ch	3.0	3.0	3.0	3.4	4.0	4.3	4.3	4.3
REAL GNP % POTENTIAL REAL GNP	.9386	.9667	.9611	.9669	.9718	.9860	.9964	.9793
INTEREST RATES								
NEW ISSUE AA INDUS BONDS	12.2	13.2	11.1	9.5	8.6	8.6	9.7	11.0
NEW ISSUE AA UTIL BONDS	12.6	13.6	11.5	9.9	9.0	9.0	10.1	11.4
30-YR GOVT SECURITIES	11.2	12.4	10.4	8.8	7.9	7.9	9.0	10.3
10-YR GOVT SECURITIES	11.1	12.4	10.3	8.7	7.8	7.8	8.9	10.2
PRIME RATE	10.8	12.0	10.4	9.2	8.1	9.0	12.3	13.9
90-DAY CDS	9.1	10.4	8.6	7.7	6.6	7.4	10.7	12.3
6-MONTH COMMERCIAL PAPR	8.9	10.1	8.4	7.5	6.4	7.2	10.5	12.1
3-MONTH T-BILL	8.6	9.5	7.9	6.9	5.8	6.6	9.9	11.5

1)PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST.

12/21/84

TREASURY

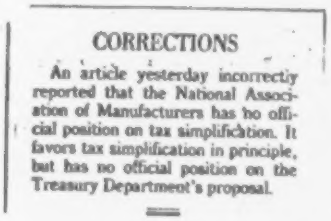
LONG-TERM ECONOMIC OUTLOOK

	1983	1984	1985	1986	1987	1988	1989	1990
MARGINAL TAX RATE	.318	.317	.321	.288	.250	.250	.250	.250
MONEY SUPPLY-(M1)	509.1	542.4	575.0	608.8	647.8	697.0	744.0	788.6
%ch	11.0	6.5	6.0	5.9	6.4	7.6	6.7	6.0
GROSS NATL PRODUCT	3304.8	3660.9	3905.0	4203.2	4523.8	4914.3	5351.7	5755.9
%ch	7.7	10.8	6.7	7.6	7.6	8.6	8.9	7.6
REAL GNP	1534.7	1637.5	1676.9	1735.3	1803.9	1898.1	1983.4	2046.1
%ch	3.7	6.7	2.4	3.5	3.9	5.2	4.5	3.2
GNP DEFLATOR	2.1534	2.2355	2.3284	2.4219	2.5076	2.5888	2.6977	2.8128
%ch	3.8	3.8	4.2	4.0	3.5	3.2	4.2	4.3
CPI-ALL URBAN	2.983	3.110	3.238	3.367	3.484	3.594	3.744	3.902
%ch	3.2	4.3	4.1	4.0	3.5	3.2	4.2	4.2
PRETAX PROFITS	203.2	235.1	238.9	284.7	317.1	363.7	411.7	426.9
%ch	22.8	15.7	1.6	19.2	11.4	14.7	13.2	3.7
PRETAX PROFITS ADJ 1)	225.2	283.1	284.6	312.2	343.2	390.7	428.6	439.4
%ch	41.5	25.7	.5	9.7	10.0	13.8	9.7	2.5
AFTER TAX PROFITS	127.4	145.4	146.0	182.1	212.4	243.7	275.8	286.1
%ch	21.6	14.1	.4	24.8	16.6	14.7	13.2	3.7
AFTER TAX PROFITS ADJ 1)	149.4	193.4	191.6	209.6	238.6	270.7	292.8	298.5
%ch	51.8	29.4	-.9	9.4	13.8	13.5	8.1	1.9
PRODUCTIVITY	1.034	1.062	1.077	1.099	1.127	1.168	1.206	1.237
%ch	3.4	2.7	1.4	2.1	2.6	3.6	3.3	2.6
EMPLOYMENT-CIVILIAN	100.8	105.0	107.0	109.4	111.6	114.0	116.4	118.7
%ch	1.3	4.1	1.9	2.2	2.0	2.2	2.1	2.0
UNEMPLOYMENT RATE	9.6	7.5	7.2	6.7	6.3	5.8	5.2	4.7
POTENTIAL REAL GNP	1644.4	1693.8	1744.7	1794.8	1856.3	1932.6	2015.7	2102.4
%ch	3.0	3.0	3.0	2.9	3.4	4.1	4.3	4.3
REAL GNP % POTENTIAL REAL GNP	.9386	.9667	.9611	.9669	.9717	.9820	.9840	.9732
INTEREST RATES								
NEW ISSUE AA INDUS BONDS	12.2	13.2	11.1	8.0	6.2	6.7	6.8	6.9
NEW ISSUE AA UTIL BONDS	12.6	13.6	11.5	8.4	6.6	7.1	7.2	7.3
30-YR GOVT SECURITIES	11.2	12.4	10.4	7.3	5.5	6.0	6.1	6.2
10-YR GOVT SECURITIES	11.1	12.4	10.3	7.2	5.4	5.9	6.0	6.1
PRIME RATE	10.8	12.0	10.4	8.2	6.3	6.6	7.6	7.9
90-DAY CDS	9.1	10.4	8.6	6.7	4.8	5.1	6.1	6.4
6-MONTH COMMERCIAL PAPR	8.9	10.1	8.4	6.5	4.6	4.9	5.9	6.2
3-MONTH T-BILL	8.6	9.5	7.9	5.9	4.0	4.3	5.3	5.6

1)PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST.

THE WASHINGTON POST

WEDNESDAY, MARCH 13, 1985



CORRECTIONS

An article yesterday incorrectly reported that the National Association of Manufacturers has no official position on tax simplification. It favors tax simplification in principle, but has no official position on the Treasury Department's proposal.

IMPACT OF TAX SIMPLIFICATION ON THE CONSTRUCTION AND REAL ESTATE INDUSTRIES

TUESDAY, APRIL 23, 1985

Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met at 10:45 a.m. in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Vento, Cooper, Kaptur, Carper, Shumway, Wortley, and Dreier.

Chairman LaFalce. The Subcommittee on Economic Stabilization will come to order.

Today's hearing is the third in a series of hearings the Subcommittee on Economic Stabilization is holding on the impact of the Treasury Department's tax simplification proposal on the different sectors of our economy.

Our first two hearings focused on the impact of the proposal on overall economic growth and on manufacturing industries. Today's hearing will examine the possible impact on the construction and real estate industries. Perhaps no sector of our economy has expressed more concern about the potential impact of the Treasury plan than construction and real estate.

Simply reading off the list of some of the provisions of the plan that concern the industry illustrates the central role tax policy has played in commercial and residential real estate development:

One, the elimination of accelerated depreciation for structures.

Two, indexing interest to inflation.

Three, lowering corporate and personal statutory tax rates.

Four, ending preferential treatment for capital gains.

Five, ending the 10-year amortization of construction period interest and dividends.

Six, ending tax-exempt bonds for housing.

Seven, ending rapid depreciation for low-income rental housing.

Eight, making at-risk rules applicable to real estate.

Nine, taxing limited partnerships with more than 35 limited partners as corporations.

Ten, limiting the mortgage interest deduction on second homes.

Industry spokesmen have argued forcefully that these and other proposals contained in the Treasury tax plan would cause a sharp decline in commercial and residential construction, raise the cost of homeownership, cause a sharp rise in rents for commercial space and apartments, and particularly harm rental housing construction.

Others who have studied the potential impact of the Treasury plan on the commercial and residential housing markets have reached different conclusions. Studies by the economists at the American Enterprise Institute, Rutgers University, and the Congressional Research Service have found that the Treasury tax plan is likely to cause a fall in interest rates of possibly 2 to 3 percent, thereby offsetting most of the consequences of eliminating tax subsidies for construction and real estate.

We are fortunate to have with us today spokesmen for two of the leading industry groups concerned about the consequences of the Treasury plan, as well as a prominent real estate economist who has studied the possible impact of the plan on real estate and construction.

I am pleased to welcome this morning John Koelemij, president of the National Association of Home Builders; Billy Carter, former brother——

[Laughter.]

Chairman LaFalce [continuing]. Billy Carter, chairman of the committee on tax and fiscal affairs of the Associated General Contractors of America; and Prof. Patric Hendershott, Galbreath Professor of Real Estate at Ohio State University.

Gentlemen, what we are going to do is put the entire text of your prepared testimony in the record and ask each of you to try to summarize your remarks, hopefully within a 10-minute period.

We will begin with the president of the Home Builders, Mr. Koelemij.

STATEMENT OF JOHN J. KOELEMIJ, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS [NAHB]

Mr. Koelemij. Thank you, Mr. Chairman.

My name is John Koelemij. It is an honor to appear before you today as president of the National Association of Home Builders, representing more than 131,000 members.

I am also a homebuilder of single family and multifamily homes and an owner of rental property in Tallahassee, FL. In the interest of time, I am going to summarize my written statement.

Mr. Chairman, I want to commend you for the series of hearings you are holding on the impact of the Treasury Department's tax reform proposals on various segments of the national economy. We appreciate your longtime support of housing and a strong national housing policy.

The Federal Government has long been committed to encouraging home ownership and decent affordable housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals.

Because of the effect of tax policy upon housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs.

Housing and Urban Development programs already have been cut by over 50 percent since 1980. Now, they are being singled out further for deep reductions or elimination.

According to NAHB's estimates, housing's share of the proposed budget reduction represents about $4 billion, or 25 percent, of the cut in discretionary spending. If these budget reductions are enacted, the HUD budget will drop from 5.3 percent of the total Federal budget in fiscal year 1980 to 0.7 percent in fiscal year 1986.

Due to this reduction in direct spending for housing programs, housing policy has shifted to the tax writing committees. Without the Tax Code, there would be no encouragement for home ownership and affordable rental housing.

Several important tax incentives have been established to promote home ownership. These include the mortgage interest deduction, the deduction for real estate taxes, the deferral of capital gains on the sale of a home, and the one-time exclusion for capital gains of up to $125,000 on the sale of a personal residence for individuals over the age of 55.

While the current version of the Treasury proposal does not tamper with mortgage interest deductions for principal residences, it would deny the deduction for property taxes and would limit the amount of interest that could be deducted with respect to mortgages on second homes.

Elimination of the deduction for property taxes would cause housing costs to increase. Moreover, elimination of this deduction would mean that homeowners will be taxed twice on the same income, once by the State or local government and again by the Federal Government.

For interest other than on mortgages on——

Chairman LAFALCE. Let me stop you right there because, although I do not intend to show support or opposition to these specific provisions as we go along, I just want to say with respect to this provision, if we were to deny the deductibility of State and local taxes, it would be the most violent assault on the concept of federalism that we have witnessed under any President in the 200-plus years that we have been a republic. The concept of double taxation by both Federal and State Governments is foreign to the concept of a dual sovereignty, let alone the impact that it would have on certain sectors, such as real estate, let alone the effect it would have about the viability of State and local governments.

Mr. KOELEMIJ. Mr. Chairman, I agree with you. I might even point out that there are tax treaties that give tax credits to foreigners to avoid double taxation, and here we would impose it for our own citizens in relationships between the Federal and State Governments.

Chairman LAFALCE. If any message is going to go out to the administration, it would seem to be that one provision that would have to be eliminated from their plan, which is nonnegotiable, at least as far as this legislator is concerned, is the provision eliminating the deductibility of all State and local taxes.

Mr. KOELEMIJ. Thank you, Mr. Chairman.

For interest other than on mortgages on principal residences, the Treasury Department has proposed an annual limitation of $5,000 plus net investment income. This limitation would apply to interest on vacation homes, automobile purchases, educational, and other consumer loans.

We are concerned with the impact that this cap could have on the economy of many communities throughout the country.

Two major home mortgage innovations that are targeted toward first-time buyers would be eliminated by the Treasury proposal. They are tax-exempt mortgage revenue bonds and builder bonds.

Approximately 1 million low- and moderate-income Americans have bought homes with assistance from the Single Family Mortgage Revenue Bond Program since the early 1970's. Mortgage revenue bonds make housing more affordable by allowing State and local housing finance agencies to convert tax-exempt funds borrowed at low interest rates into mortgages that are typically 2 or 2½ percentage points below the conventional mortgage rate. Loans funded by mortgage revenue bonds are restricted by Federal law to first-time buyers of modestly priced homes.

Tax incentives attracting investment capital have been the lifeblood of the rental housing market, which serves one-third of all American households, including the poor, who cannot afford to own their own homes. Without tax incentives to encourage the private sector to build rental housing, the Federal Government's obligation to directly assist low-income Americans in obtaining shelter would have to be far greater than it is today.

The Treasury proposal would affect investment in rental housing in many ways, as outlined in our statement. From the investment point of view, rental housing often has been unattractive.

Intensive management is necessary both to maintain rental housing and to assure a steady stream of income. The cost of maintenance of rental property has increased considerably in the past years. Furthermore, income generated from rental property is lower than for other types of property.

In fact, to obtain a reasonable return on investment, present tax preferences are needed, and, furthermore, these tax preferences are necessary to maintain the viability of existing low- and moderate-income housing units. Tenant income would not support the rents necessary in the absence of tax incentives.

These are the reasons that rental housing must retain current depreciation allowances and other tax incentives in order to be competitive with other types of investments.

The proposal to index interest would have at least two adverse consequences. It would reduce the after-tax return on real estate investment and also would introduce an element of uncertainty in expected yields and cash flows. Mr. Chairman, this provision appears to be the most troublesome item in the Treasury proposal.

Tax-exempt industrial development bonds have been a major source of financing for newly constructed low- and moderate-income rental housing. Tax-exempt IDB's can reduce the interest rate on multifamily mortgages by 200 basis points or more, making it possible for investors to build projects that otherwise might not have been feasible, and thus contributing to moderation in rents. The elimination of IDB financing would remove the current primary source for financing new moderate income rental housing.

The Treasury proposal would treat interest expense from limited partnerships as investment interest and, further, would limit the deduction of investment interest to $5,000 plus net investment income.

In addition, the Treasury proposal would curtail the use of limited partnerships as a real estate investment vehicle by limiting the number of limited partners to 35 persons.

Finally, the Treasury proposal would extend the at-risk rules to real estate investments.

The economic impacts of the proposed changes in the Tax Code are likely to be pervasive and are not well understood. The Treasury Department has not produced any comprehensive and quantitative assessment of the economic impact.

One of the key issues is the impact on overall economic growth. Although the Treasury report, issued in November 1984, referred to fairness, simplicity, and economic growth, there is little evidence that these changes would actually promote economic growth.

Some maintain that market forces of supply and demand are the only way to allocate resources in such a way as to optimize economic growth. We disagree.

Concerning overall economic growth, few economists would view an economically neutral income tax as producing a higher standard of living over time compared to a system with appropriate investment incentives.

We believe specific incentives for capital formation and risk-taking, such as accelerated depreciation and reduced tax rates for capital gains, produce growth of output, employment, and productivity beyond that provided by an economically neutral tax system. The Treasury Department has produced no evidence to the contrary.

NAHB has not conducted extensive research on the host of possible macroeconomic effects of comprehensive tax reform. We have, however, conducted a thorough analysis of the potential impacts on the cost of housing and housing activity. A report summarizing the results of that analysis is being submitted as an appendix to our testimony.

The proposed changes in the tax treatment of homeowners under the Treasury proposal would raise the overall after-tax cost of home ownership for a typical recent home buyer with a $40,000 income by about 20 percent. As a result of the increase in home ownership cost, house prices are likely to decline moderately.

The decline in house prices would be an advantage to first-time buyers, but the two-thirds of U.S. households who currently own homes would face a decline in value of their homes, which would represent a significant hardship. Such a decline undoubtedly would also produce an increase in mortgage defaults and foreclosures, further weakening the savings and loan industry because of their portfolio holdings.

The decline in house prices is unlikely to be large enough to offset the increase in after-tax home ownership costs. House prices are ultimately determined by the cost of building additional homes, and except for the cost of raw land, those costs are unlikely to fall. Thus, the net cost of home ownership after the markets have fully adjusted will still increase.

For moderate income first-time buyers, who benefit from lower rate mortgages funded by mortgage revenue bonds or builder bonds, the impact of the Treasury proposal would be even greater. The cost of home ownership would be increased by an additional 10 to 25 percent as a result of the elimination of these financing mechanisms. The impact of the Treasury proposal on rental housing would be far more severe. If all the provisions of the Treasury proposal were implemented, the rents required to provide an adequate return to investors in new conventionally financed rental housing would be more than 40 percent above the rents required under current law, assuming no change in interest rates or other costs.

For moderate income rental housing that is currently financed by tax exempt industrial revenue bonds, the increase in required rents would be over 60 percent. Actual increases in rents of that magnitude would not occur over the short run. The impact would instead be a virtual elimination of new construction of multifamily rental housing and a sharp drop in the value of existing properties.

Shortages of rental housing would develop as the normal increase in demand collided with minimal new construction, conversion of rental properties to owner occupancy and abandonments. Gradually, market rents would increase to the level necessary to justify new construction.

The primary burden of this painful adjustment process would fall on lower income households, who would see their housing deteriorate and rents increase to a greater extent than higher income renters. Many families in the lowest income strata could literally be left homeless.

The drop in construction activity would also have adverse impacts on the overall economy. If all the provisions of the Treasury proposal were immediately implemented, we estimate it would produce a decline in housing starts next year of approximately 500,000 units, resulting in a decline in employment in construction and related industries of nearly 600,000 man-years. While other industries might be expected to expand as a result of the proposed changes, such expansion is not likely to occur as quickly, and the net result would be a major contraction in the economy.

In conclusion, Mr. Chairman, NAHB has spent a substantial amount of time reviewing the Treasury tax reform proposals and other proposals that have been introduced. All these proposals would have an adverse effect on housing and real estate. We feel that as the Congress considers tax reform, it should keep in mind certain basic principles.

One, home ownership should be encouraged. Tax changes should not increase the cost of home ownership, particularly for those who are just entering the housing market.

Two, incentives for capital investment, particularly for the construction and ownership of rental housing, should be maintained. Moreover, special consideration should be given to low- and moderate-income housing needs.

Third, the tax system should foster savings and capital formation; economic productivity and growth require private capital formation.

And, last, frequent changes in the tax law should be discouraged. Tax changes create an investment uncertainty; thus, any further changes should attempt to minimize potential market dislocations. It is essential that there be certainty in order to allow for long-range planning.

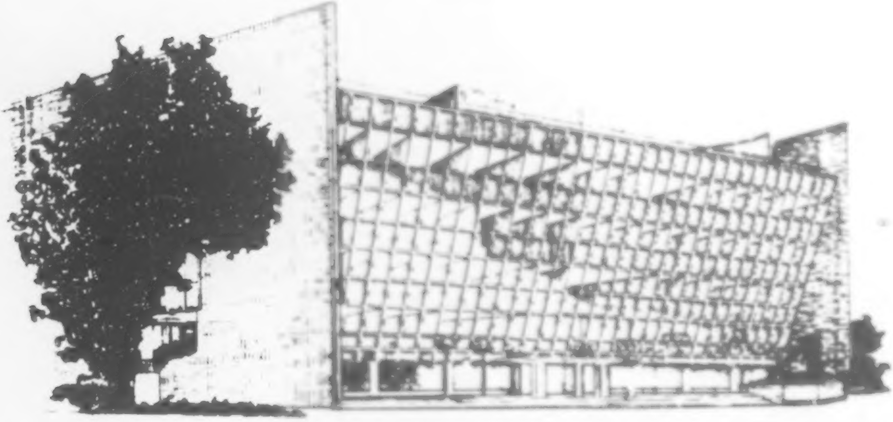
Mr. Chairman, again, I thank you for the opportunity to testify and I'll be ready to answer any questions you or other members might have.

Chairman LAFALCE. Thank you very much, Mr. Koelemij.

[The prepared statement of Mr. Koelemij, on behalf of the National Association of Home Builders, and an association report "Summary Analysis of the Impacts of Tax Reform Proposals on Housing Costs and Housing Activity," follow:]

Statement of the NATIONAL ASSOCIATION OF HOME BUILDERS before the

Committee	Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs/U.S. House of Rep.
Subject	Impact of Treasury Department Tax Reform Proposals on Real Estate
Witness	John J. Koelemij, President
Date	April 23, 1985
Place	2128 Rayburn House Office Bldg.



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STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SUBCOMMITTEE ON ECONOMIC STABILIZATION
of the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
on
IMPACT OF TREASURY DEPARTMENT'S
TAX REFORM PROPOSALS ON REAL ESTATE

April 23, 1985

Mr. Chairman and Members of the Subcommittee:

My name is John Koelemij and it is an honor to appear before you today as President of the National Association of Home Builders (NAHB), representing more than 130,000 home builders. I am also a home builder of single family and multifamily homes and an owner of rental property in Tallahassee, Florida.

Mr. Chairman, I want to commend you for the series of hearings you are holding on the impact of the Treasury Department's tax reform proposals on various segments of the national economy. These types of Congressional hearings are necessary because if comprehensive tax reform is enacted, Congress first should explore all of the ramifications that such legislation would have upon the economy. Furthermore, if the Internal Revenue Code is to be overhauled, it should be done in a manner to cause the least possible economic disruption.

I. Overview

The Federal Government long has been committed to encouraging housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals. Home owners have relied on the deductibility of mortgage interest and property taxes to help them achieve home ownership, and renters have benefited from the tax incentives provided for individuals to invest in rental housing. This tax policy has made possible increased rates of home ownership, a comfortable standard of housing for most households, and a steady decline in the amount of substandard housing.

Affordable rental housing is an essential part of our social policy today. Rental housing must be available for those who are unable financially or who do not desire to own their own home. As I will explain, further, rental housing would not be an attractive investment without tax incentives. Absent tax incentives, the availability of rental housing would decline and the cost to renters would increase.

Because of the effect of tax policy upon housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs. Housing and urban development already have been cut by over 50% since 1980. Now they are being singled out further for deep reductions or elimination. According to NAHB estimates, housing's share of the proposed budget reductions represents about $4 billion or 25% of the cut in discretionary spending. Given the enormous redutions in housing related programs since 1980, this is simply not fair or responsive to the growing needs of lower income families and the elderly. If these budget reductions are enacted, the HUD budget will drop from 5.3% of the total Federal budget in FY'80 to 0.7% in FY'86. Given this reduction in direct spending for housing programs, it is clear that housing policy now has shifted to the tax writing committees.

Tax policy is of major importance to those who construct housing, to those who finance housing, and, thus, to those who reside in housing. We need a consistent tax policy that reaffirms our national commitment to affordable, quality housing -- both for home ownership and for rental housing. A consistent policy of support for decent housing and home ownership has been a national commitment for more than fifty years. This principle should be a priority in any tax policy.

Enactment of the Treasury proposals would have a profound effect upon individuals and businesses, particularly the real estate sector, as well as on home buyers, home owners, and renters. In fact, the Treasury proposals represent a fundamental change in the philosophy and objectives of taxation affecting many areas of the economy, and those effects must be weighed before proceding with comprehensive tax revision.

II. Tax Incentives and Housing Policy

Homeowners

Several Important tax incentives have been established for owner-occupied housing. These include the mortgage interest deduction, the deduction for real estate taxes, the deferral of capital gains on the sale of a home, and the one-time exclusion for capital gains of up to $125,000 on the sale of a personal residence for individuals over age 55.

Of all tax deductions allowed by present law, the mortgage interest deduction coupled with the deduction for property taxes, probably has the highest level of appeal to middle-class Americans. These deductions make homeownership affordable for many Americans. For example, take a married couple with two children and filing a joint return. Under current tax law, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family afford a $74,000 home. Without the mortgage interest deduction, the same family could afford only a $59,000 home. With the median price of a new home in the $80,000 range, the importance of the mortgage interest deduction in permitting ownership of a home is evident.

While the current version of the Treasury proposal does not tamper with the mortgage interest deduction for principal residences, it would deny the deduction for property taxes and would limit the amount of interest that could be deducted with respect to mortgages on second homes. As I will explain, further, elimination of the deduction for property taxes would cause housing costs to increase. Moreover, elimination of this deduction would mean that home owners will be taxed twice on the same income, once by the State or local government and again by the Federal Government.

For interest other than on mortgages on principal residences, the Treasury has proposed an annual limitation of $5,000 plus net investment income. All interest other than that with respect to owner-occupied homes would be under this cap. Thus, the cap would apply to interest on vacation homes, automobile purchases, and other consumer loans. We are concerned with the impact that this cap could have on vacation communities. In addition, we are concerned that should Congress enact a cap on interest deductions other than those with respect to mortgages on principal residences, it might not be too long before the Treasury Department sought to place a cap on those deductions.

In summary, we are pleased that the Treasury proposal has retained the full deduction of interest payments on principal residences, rollover of capital gains, and the exclusion for gains of home sellers over age 55. However, as I will explain more fully in my testimony, in the absence of interest rate declines, the net effect of the proposal will be to increase the cost of home ownership and reduce the value of existing homes.

First-time Homebuyers

Two major home mortgage innovations that have helped to address the problem of affordability of homes are tax-exempt mortgage revenue bonds and builder bonds.

Approximately one million low - and moderate - income Americans have bought homes with help from the single-family mortgage revenue bond program since the early 1970's. Mortgage revenue bonds make housing more affordable by allowing State and local housing finance agencies to convert tax-exempt funds borrowed at low interest rates into mortgages that are typically 2 or 3 percentage points below the conventional mortgage rate.

Loans funded by mortgage revenue bonds are restricted by Federal law to first-time buyers of modestly-priced homes. In addition, these loans are targeted to economically-distressed areas, and most State and local issuers impose income limits. We are dismayed that the Treasury Department has proposed repeal of mortgage revenue bonds because they have been an effective means of providing affordable financing to households who otherwise would be stymied from achieving home ownership due to continuing high interest rates. In fact, home ownership among young families has been on the decline for the last five years.

As I earlier mentioned, another home mortgage innovation that has helped to address the affordability problem is builder bonds. Unlike a traditionally-financed home sale in which the builder receives cash at closing, under a builder bond program, the builder receives a downpayment and takes back a mortgage. The builder then receives regular principal and interest payments until the mortgage is retired. Because the builder receives only a portion of the purchase price each year, the builder's early year tax liability is substantially lower than for the traditionally-financed builder. This installment sale tax treatment commonly is used by large corporations in other industries with financing subsidiaries. The adaptation of the installment sale tax treatment to the home building industry has substantial benefits both for home builders and home buyers.

Builder bonds allow the builder to tap directly into the national capital markets to provide home buyer financing. The builder uses a pool of mortgages or mortgage-backed securities to collateralize the bond issue. The development of builder bonds has led institutional investors to show an unprecedented willingness to channel their capital into housing. In addition, the typical builder bond financed buyer is paying a full percentage point less than other buyers using fixed rate mortgages. Because the current year tax liability of the bond-financed builder is lower, builders can provide affordably priced and financed housing.

While builder bonds are not restricted, specifically, to moderate-income first-time home buyers, they have been used primarily by large tract builders offering FHA and VA loans. Thus, they primarily have benefited buyers at the lower end of the market.

The Treasury department's proposal to deny installment sales treatment to builders who pledge mortgages as collateral for bonds would curtail the development of builder financing and raise mortgage rates and home prices. Furthermore, we feel that the denial of installment sale treatment where the obligation is used as collateral is inequitable, because highly liquid consumer finance companies, whose superior access to credit markets precludes the need to pledge receivables as collateral, would still enjoy the installment sale tax advantage.

Rental Housing

Tax incentives attracting investment capital have been the lifeblood of the rental housing market, which serves one-third of all American households, including the poor who cannot afford to own their own homes. Without tax incentives to encourage the private sector to build rental housing, the Federal Government's obligation to assist low-income Americans in obtaining housing would have to be far greater than it is today.

The taxation of investment in rental housing is complex. Different provisions in the Internal Revenue Code affect a variety of participants in the development process: developers, builders, syndicators, and investors. The major tax provisions that have affected rental housing are:

- The accelerated cost recovery system (depreciation).
- Rehabilitation tax credits.
- Capital gains exclusion.

° Forms of ownership that allow for "flow-through" taxation as a way to attract capital.

° Exemption from the "at-risk" rules.

° 10-year amortization for construction period interest and taxes.

° Tax-exempt industrial development bonds.

The Treasury proposal would affect investment in rental housing by:

° Reducing the depreciation allowance for rental structures to three percent per year, calculated on an indexed basis.

° Including construction period interest and taxes in depreciable basis (instead of 10-year amortization).

° Replacing the capital gains exclusion with indexation of basis.

° Indexing interest.

° Treatment of limited partners' interest as investment interest.

° Limitation of investment interest deductions to investment income, plus $5,000.

° Elimination of industrial development bonds.

° Limitation of 35 limited partners per partnership.

° Elimination of all special treatment for low-income housing.

° Elimination of rehabilitation tax credits.

We believe that changes in the current tax rules severely would disadvantage investment in rental housing compared to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes be capitalized was enacted in 1976. That provision requires that construction period interest and taxes either be added to the basis of property or be amortized over a 10-year period. Residential real estate also does not enjoy the advantage of the investment tax credit, except in the case of rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds. Finally, the Deficit Reduction Act of 1984 (DEFRA) had a significant impact upon investments in real estate. Among the many significant items in DEFRA affecting real estate investments were provisions that:

- Increased the recovery period for real property (other than low-income housing) from 15 years to 18 years;
- Imposed immediate recapture of depreciation in installment sales;
- Restricted issuance and use of industrial development bonds;
- Expanded the original issue discount rules to cover sales of property;
- Limited deductions of start-up costs for new ventures;

- Imposed higher test and imputed interst rates on transactions involving deferred payment sales of property;

- Expanded the rules relating to amortization of construction period interest and taxes; and

- Eliminated tax-free exchanges of partnership interests, and tightened up generally in the area of partnerships.

We believe that the ACRS recovery allowance for structures, adopted in 1981, should not be revised to reduce current depreciation allowances.

From an investment point of view, rental housing often has been unattractive. Intensive management is necessary both to maintain rental housing and to assure a steady stream of income. The cost of maintenance of rental property has increased considerably in recent years. Furthermore, income generated from rental property is lower than for other types of property.

Residential rents generally do not provide for CPI inflation increases, and the income of residents can support only a certain level of rent. Accordingly, market rents generally do not create an income stream that is competitive with other types of investments. Moreover, rent controls in many juridisdictions have kept rents at below market levels.

These are the reasons that residential housing must retain current depreciation allowances in order to be competitive with other types of investments. A reduction in present depreciation allowances, shortly following the DEFRA reduction, would drive capital away from residential housing at a time when more, rather than less, capital is needed.

In 1981, NAHB supported ACRS depreciation because of its certainty and simplicity. However, it is a misconception to believe that ACRS significantly increased depreciation deductions for new residential construction. In fact, under the law prior to the 1981 Tax Act, component depreciation plus the ability to use the double declining balance method of depreciation sometimes provided a more advantageous depreciation situation for new housing than was the situation after ACRS. Component depreciation often provided larger total depreciation deductions over the first six years than does ACRS.

While I have dwelled somewhat on depreciation, there are several other aspects of the Treasury tax reform proposal that would have an adverse impact on rental housing. Let me now highlight some of these proposals.

The proposal to index interest would have at least two adverse consequences. It would reduce the after-tax return on real estate investment and also would introduce a new element of uncertainty into expected yields and cash flows. If this provision were to be enacted, an investor obtaining long-term financing would not know in advance how much of the interest expenses would be deductible.

Tax-exempt industrial development bonds (IDBs) have been a major source of financing for newly-constructed low- and moderate-income rental housing. During 1984, IDB financing apparently was used for the majority of low- and moderate-income rental housing in structures with five or more units. Tax-exempt IDBs can reduce the interest rate on multifamily mortgages by 200 basis points or more, making it possible for investors to build projects that otherwise might not have been feasible and, thus, contributing to moderation in rents. The elimination of IDB financing would remove the current primary source for financing new moderate-income rental housing.

The proposal to eliminate the capital gains deduction, if enacted, would mean that investors would have a higher price to pay when they dispose of an investment interest. No doubt, this would have an impact on the decision of whether or not to invest in the first place.

The Treasury proposal not only would cut back on incentives for investment in residential property and eliminate tax-exempt IDB financing, but it also would place restrictions on limited partnerships. Largely because of their flexibility, their ability to accomodate large numbers of investors, limited liability, and the "flow-through" of tax attributes from the partnership to the investor, limited partnerships have become the primary vehicle for equity investment in rental properties.

The Treasury has proposed to restrict the usefulness of limited partnerships as an investment vehicle in several ways. Present law limits the deductibility of "investment interest," but interest incurred in a trade or business even if the investor is not actively engaged in the management of the business is fully deductible. This current deductibility of interest is an important feature of investments in real estate limited partnerships. The Treasury proposal would treat interest expense from limited partnerships as investment interest and, further, would limit the deduction of investment interest to $5,000 plus net investment income. Furthermore, the Treasury proposal would curtail the use of limited partnerships as a real estate investment vehicle by limiting the number of limited partners to 35 persons. A limited partnership with more than 35 persons would be treated as a corporation for Federal income tax purposes. Finally, the Treasury proposal would extend the "at-risk" rules to real estate investments. Currently, lenders to real estate activities generally look only to the value of the property securing the loan in the case of default. That is, the limited partners generally have no personal liability with respect to the borrowed funds, except to the extent of their cash investment. This is another feature of present law that makes the limited partnership an attractive vehicle for investments in real estate. The extension of the at-risk rules to real estate would force investors in real estate either to accept personal liability for debts of the partnership or to face reduced tax benefits. The net result of imposing these limited partnership restrictions would be to restrict investment in large real estate developments to the very wealthy investor able to raise enough capital from a small number of partners. The application of the at-risk rules also would provide an incentive for more rapid, uneconomic turnover of real estate investments.

While it is difficult to quantify the likely impact of these restrictions on limited partnerships, we are concerned that these proposals could restrict severely the free flow of capital into housing.

III. Economic Impacts

The economic impacts of the proposed changes in the tax code are likely to be pervasive and are not well understood. The Treasury Department has not produced any comprehensive and quantitative assessment of the economic impact. While some private forecasters have attempted to estimate the impacts, their results have been based on crude characterizations of these complex proposals. The reality is that existing macroeconomic models do not have built-in levers to simulate the impact of these major reforms, and there is no historical experience from which to estimate new econometric equations.

We cannot provide any precise estimates of the full range of impacts on the overall economy, but we would like to raise a few issues and suggest some preliminary hypotheses with regard to the macroeconomic issues.

One of the key issues is the impact on overall economic growth. Although the Treasury report issued in November, 1984, referred to "Fairness, Simplicity, and Economic Growth," there is little evidence that these changes would actually promote economic growth. In his testimony to the Ways and Means Committee on February 27, Secretary Baker stated:

> "Most economists agree on one thing: whenever the tax structure is designed to function in a capacity other than to raise revenues to finance government activities, there will be a misallocation of productive resources -- labor and capital -- away from their most productive uses. Only the market forces of supply and demand can allocate resources in such a way as to optimize economic growth; any other allocation, no matter how well intended and how carefully planned, runs the risk, in the long run, of leading to a lower standard of living for all of us".

We beg to disagree with this statement. Moreover, we think that the statement misrepresents most economists. Tax incentives certainly allocate more resources to some activities than would the market place. However, this reallocation reflects conscious public policy decisions and thus should not be labeled "misallocation". We submit that tax incentives have been shown to be an efficient, effective way of achieving specific economic and social objectives. In addition, tax incentives harness the energies and information of the market place, rather than of a bureaucracy, to achieve those objectives.

Concerning overall economic growth, even fewer economists would view an "economically neutral" income tax as producing a higher standard of living over time compared to a system with appropriate investment incentives. Like most economists we believe specific incentives for capital formation and risk taking -- such as accelerated depreciation and reduced tax rates for capital gains -- produce growth of output, employment, and productivity beyond that provided by an "economically neutral" tax system. The Treasury Department has produced no evidence to the contrary.

The Treasury Department has suggested that the proposed reductions in marginal tax rates and the indexation of interest would lower market interest rates, and thus benefit housing and other sectors of the economy. While we agree that these proposed changes would tend to depress interest rates somewhat, we believe the reduction in rates would be small and the effect would be highly uncertain. One major factor which conflicts with simplistic notions of the way interest rates would adjust is the fact that the U.S. capital market has become increasingly linked with, and dependent upon, international markets. Large proportions of domestic borrowing and lending also would be unaffected by the proposed tax changes.

One macroeconomic impact of the Treasury proposal which has been generally overlooked is the potential impact on the cost of living. The Treasury proposal would cut individual tax liabilities while raising taxes on business. There's no free lunch to be had through such a shift. Much of the higher tax on businesses would be passed on to consumers in the form of higher prices. The price increases would probably affect the lowest income groups most severely. It clearly is important to distinguish between who actually sends money to the Treasury and who ultimately bears the burden of taxation.

NAHB has not conducted extensive research on the host of possible macroeconomic effects of comprehensive tax "reform." We have, however, conducted a thorough analysis of the potential impacts on the cost of housing and housing activity. A report summarizing the results of that analysis is being submitted as an appendix to our testimony. Let me summarize the results of our studies.

The proposed changes in the tax treatment of homeowners under the Treasury proposal would raise the overall after-tax cost of homeownership for a typical recent homebuyer with $40,000 income by about 20 percent. This does not mean that such a household will necessarily pay more taxes, but the cost of homeownership would rise relative to the cost of other goods and services.

As a result of the increase in home ownership cost, house prices are likely to decline moderately. The decline in house prices would be an advantage to first-time buyers, but the two-thirds of U.S. households who currently own homes would face a decline in the value of their homes which would represent a significant hardship. Such a decline undoubtedly would also produce an increase in mortgage defaults and foreclosures.

The decline in house prices is unlikely to be large enough to offset the increase in after-tax homeownership costs. House prices are ultimately determined by the cost of building additional homes, and except for the cost of raw land, those costs are unlikely to fall. Thus, the net cost of homeownership after the markets have fully adjusted would still increase.

For moderate-income first-time buyers who currently benefit from low-rate mortgages funded by Mortgage Revenue Bonds or Builder Bonds, the impact of the Treasury proposal would be much more severe. The cost of homeownership would be increased by an additional

10 percent to 25 percent as a result of the elimination of these financing mechanisms.

The impact of the Treasury proposal on rental housing would be far more severe. If all the provisions of the Treasury proposal were implemented, the rents required to provide an adequate return to investors in new conventionally-financed rental housing would be more than 40 percent above the rents required under current law, assuming no change in interest rates or other costs. For moderate-income rental housing that is currently financed by tax-exempt Industrial Development Bonds, the increase in required rents would be over 60 percent.

Actual increases in rents of that magnitude would not occur over the short run. The impact would instead be a virtual elimination of new construction of multifamily rental housing and a sharp drop in the value of existing properties. Shortages of rental housing would develop, as the normal increase in demand collided with minimal new construction, condominium conversions, and abandonments. Gradually, market rents would increase to the level necessary to attract new construction.

The primary burden of this painful adjustment process would fall on lower income households, who would see their housing deteriorate and rents increase to a greater extent than higher income renters. Many families in the lowest economic strata could literally be left homeless.

The drop in construction activity would also have adverse impact on the overall economy. If all the provisions of the Treasury proposal were immediately implemented, we estimate it would produce a decline in housing starts next year of approximately 500,000 units, resulting in a decline in employment in construction and related industries of nearly 600,000. While other industries might be expected to expand as a result of the proposed changes, such expansion is not likely to occur as quickly and the net result would be a major contraction in the economy.

IX. Conclusion

NAHB has spent a substantial amount of time reviewing the Treasury tax reform proposals and other proposals that have been introduced. We feel that as the Congress considers tax reform, it should keep in mind certain basic principles:

° Home ownership should be encouraged. Tax changes should not increase the cost of homeownership, particularly for those who are just entering the housing market. Any changes to the tax law should maintain existing property values and should not result in diminishing the value of homeownership -- which often is a family's major investment. Homeownership also is important for the community because it provides for social and political stability.

° Incentives for capital investment, particularly for the construction and ownership of rental housing should be maintained. Moreover, special consideration should be given to low-income housing needs. Incentives directed toward capital formation for rental housing, particularly ACRS depreciation allowances and the use of partnerships as a means of capital accumulation for investment in rental housing should be maintained and strengthened.

° The tax system should foster savings and capital formation. Economic productivity and growth require private capital formation. Thus, incentives to save and invest should remain an integral part of the tax system.

° Reform should facilitate tax compliance with an eye towards deficit reduction. Reform for the sake of reform is not enough. While the current tax law may be far from perfect, for many taxpayers who use the standard deduction, it is relatively simple. Furthermore, current tax law promotes desirable economic and social goals.

° Frequent changes in the tax law should be discouraged. Tax changes create investment uncertainty. Thus, any future changes should attempt to minimize potential market dislocations. It is essential that there be certainty in order to allow for long-range planning.

Finally, Mr. Chairman, we wonder why the rush for tax reform? Since 1981, three major pieces of tax legislation have been enacted. The Economic Recovery Tax Act of 1981 provided much-needed tax incentives in order to stimulate economic recovery. The Tax Equity and Fiscal Responsibility Act of 1982 cut back somewhat on the incentives provided by the 1981 Tax Act in order to help reduce the Federal deficit. Then in 1984, the Deficit Reduction Act further cut back these incentives. The 1984 Tax Act will amount to an approximately $8 billion tax increase for housing and the real estate industry through 1987. While we generally support eforts to reduce the deficit, we wonder how much more of the burden real estate and the housing industry will be asked to shoulder.

If there is a general consensus that the tax code must be reformed, we feel that Congress should proceed in an orderly fashion. Tax incentives that have served useful purposes should not be lightly discarded. Rather, they should be studied thoroughly to determine whether or not they are still desirable or are in need of modification. We at the NAHB are willing to work with the Congress to develop a sound tax policy.

Again, I thank you for the opportunity to testify and now will be glad to answer any questions you may have.

Summary Analysis of the Impacts of Tax Reform Proposals On Housing Costs and Housing Activity

National Association of Home Builders
Division of Housing Policy and Mortgage Finance
March 1, 1985

ABSTRACT

The tax reform proposal submitted to the President by the Department of the Treasury, and the Bradley-Gephardt and revised Kemp-Kasten legislative proposals, all would have adverse impacts on housing costs and housing activity.

The tax proposals would raise the cost of homeownership for many households. The largest increases would occur under the Treasury and Bradley-Gephardt proposals. Reductions in marginal tax rates, elimination of many deductions, and increases in the zero-bracket amount would reduce the value of the mortgage interest deduction -- a provision that generally would be retained. Furthermore, all three proposals would eliminate tax-exempt Mortgage Revenue Bonds, a major factor in making homeownership affordable for moderate-income, first-time homebuyers. The Treasury proposal would also curtail builder financing of home purchases, a technique that recently has lowered costs of homeownership.

The Treasury proposal would have even larger adverse impacts on rental housing. For a typical multifamily development, the Treasury proposal would raise rents required to make new construction feasible by about 40% as a result of reduced deductions for interest expense, reduced depreciation allowances, taxation of capital gains at higher rates, and reductions in marginal tax rates for ordinary income. Taking into account the fact that the Treasury proposal would eliminate tax-exempt financing for low- and moderate-income rental housing, the increase in rents required to make the typical low- or moderate-income project feasible would be about 60%. The Treasury proposal also includes provisions to extend "at risk" requirements to real estate and to severely restrict limited partnerships, thereby restricting the flow of equity capital into real estate.

The recently revised Kemp-Kasten proposal would have the smallest negative impact on rental housing of the three proposals. This is because it provides for greater investment incentives and places fewer restrictions on limited partnerships. However, it would sharply cut marginal tax rates and eliminate provisions that currently assist low- and moderate-income renters, raising required rents around 27% for projects currently relying on tax-exempt industrial development bond financing and eliminating rapid depreciation for rehabilitation.

The Bradley-Gephardt proposal would impact investment in rental housing less than Treasury, but significantly more so than Kemp-Kasten.

In terms of potential impact on new construction, full implementation of the Treasury proposal would produce an initial modest decline in single-family starts, which would gradually recover over a period of two to three years to the level they would have attained under current law. The decline in single family starts would be primarily due to the elimination of mortgage revenue bonds. Multifamily starts under the Treasury proposal would be impacted much more severely, with starts falling by two-thirds and recovering very slowly. The potential possible effect on total starts in the first year would be a reduction of 500 thousand to 600 thousand units. A reduction in construction activity of that magnitude would directly cause the loss of over half a million jobs.

Under Bradley-Gephardt, single-family starts would be weaker and multifamily starts would be stronger than under the Treasury plan. Under Kemp-Kasten, the drop in both single-family and multifamily starts would be less severe than under either the Treasury or Bradley-Gephardt proposals.

Some of the sponsors of these proposals argue that despite the fact that they do not directly address the problem of the deficit, the tax changes would reduce interest rates by increasing both after-tax returns to lenders and after-tax costs for borrowers. Our analysis supports the hypothesis that the tax proposals would tend to have a downward influence on rates; however, the decline in rates would be modest, primarily because many of the most important borrowers and lenders, including foreign investors, would be unaffected by the proposals.

The effect of the proposed tax changes on property values would be relatively modest in the case of single-family homes, with an average decline in value on the order of 5%. The biggest declines would occur for more expensive homes, particularly where the house price reflects high land costs. For rental properties, however, declines of 20% to 30% in resale value could occur in many areas, increasing the likelihood of mortgage default, particularly for highly-leveraged government-insured loans.

INTRODUCTION

The Federal Government traditionally has sought to encourage homeownership and to help provide decent, affordable housing for all Americans. The Federal income tax system has been one of the primary mechanisms used to pursue these objectives. A variety of incentives have been incorporated in the tax code to promote both homeownership and investment in rental housing.

Several proposals to "simplify" or "reform" the tax system have recently been put forth. The three proposals receiving the most attention have been the proposal submitted to the President by the Department of the Treasury in November, 1984, and the (revised) Kemp-Kasten and Bradley-Gephardt proposals submitted as legislation in the Congress. All of these proposals would lower marginal tax rates, subject more income to tax, and simplify tax calculations for individuals. All proposals also purport to be "revenue neutral", raising the same amount of revenue as the current tax system.

The Treasury proposal goes beyond the objectives of rate-flattening, base-broadening, and simplification, to also seek "economic neutrality". Achievement of economic neutrality requires removal of the incentives incorporated in the tax code over the years to promote economic and social objectives such as business investment, private charitable contributions, and local economic development -- as well as the provision of affordable housing and the promotion of homeownership. The Treasury Department proposal also attempts to neutralize the effects of inflation on the tax system. Adjustment for inflation involves "indexation" of a broad range of tax provisions, and affects the tax treatment of capital gains and losses, depreciation allowances, and interest income and expenses.

All three tax proposals have important implications for the housing costs facing homeowners and renters and for the volume of housing construction. In order to examine the likely impacts of these proposals relative to current law, NAHB has constructed computer simulation models of homeowner and rental costs and reviewed the implications of each proposal. The major provisions affecting housing and the findings of the analysis are summarized in this document. The potential impacts on costs of homeownership and rental housing are reviewed first, followed by a discussion of the possible impacts on construction activity. The latter sections of the paper consider problems associated with uncertainty and transition, possible impacts on market interest rates, and impacts on property values and indices of general inflation.

IMPACTS ON HOMEOWNERS

The major provisions affecting homeowners in each of the three proposals are summarized in Exhibit 1. A number of general provisions have important implications, in addition to those specifically related to housing. All three proposals lower and flatten the structure of personal tax rates. That is, marginal tax rates - the rates paid on each additional dollar of taxable income - are sharply reduced, even though the actual taxes paid by households may change only slightly. Because deductions create tax savings based on marginal rates, the reduction in marginal tax rates reduces the value to the taxpayer of allowable deductions. The value of allowable housing-related deductions would also be reduced by increases in the standard deduction (zero bracket amount) and/or reductions in non-housing deductions, because a taxpayer must choose between itemizing deductions and taking the standard deduction. If non-housing deductions are less than the standard deduction, all or part of the housing deductions produce no net tax savings.

All three proposals continue the home mortgage interest deduction in some form. Under the Treasury proposal, full deductions for mortgages on principal residences are retained, although deductions for other consumer interest, including interest on loans for second homes, are limited. The Bradley-Gephardt proposal allows the deduction of mortgage interest only at the 14% base tax rate, despite the fact that the top tax rate on income under Bradley-Gephardt is 30%. Under Kemp-Kasten, the deduction is always applied at the 24% rate, even for people whose effective marginal tax rate on income is only 19%. Thus, in both Bradley-Gephardt and Kemp-Kasten the deduction effectively becomes a tax credit, with the value of that credit much lower under Bradley-Gephardt.

The Treasury proposal would eliminate deductions for state and local property taxes. Under Bradley-Gephardt and Kemp-Kasten the property tax deduction would, like home mortgage interest, be retained in a form that is similar to a tax credit.

EXHIBIT 1

PROPOSED TAX CHANGES
AFFECTING HOMEOWNERSHIP COSTS

GENERAL PROVISIONS	TREASURY DEPARTMENT	KEMP-KASTEN	BRADLEY-GEPHARDT
Personal Income Tax Rates (Current Law: 14%-50%)	15% - 35%	19% - 29%	14% - 30%
Personal Exemption (Current Law: $1,090 in 1986)	$2,000	$2,000	Self, Spouse: $1600 Others: $1,000
Standard Deduction (Married) (Current Law: $3,710 in 1986)	$3,800	$3,300	$6,000
Indexed Brackets & Exemption (Current Law: Yes)	Yes	Yes	No
Capital Gains Tax Rate (Current Law: 40% of Full Rate)	Full Rate, with indexation of basis	Choice of full rate with indexation or 60% of full rate with no indexation	Full Rate, with no indexation
Non-Housing Deductions: (Current Law: Fully Deductible)			
State and Local Income Taxes	No	No	Yes***
Other Taxes	No	No	No
Consumer Interest	Limited*	No	Limited*
Charitable Contributions	Limited	Yes**	Yes***

PROPOSED TAX CHANGES
AFFECTING HOMEOWNERSHIP COSTS
(continued)

HOMEOWNER PROVISIONS	TREASURY DEPARTMENT	KEMP-KASTEN	BRADLEY-GEPHARDT
Homeowner Deductions: (Current Law: Fully Deductible)			
Mortgage Interest			
* Principal Residence	Yes	Yes **	Yes ***
* Vacation Homes	Limited*	Yes **	Yes ***
Property Taxes	No	Yes **	Yes ***
Rollover of Capital Gains (Current Law: Yes)	Yes	Yes	Yes
One-Time Exclusion of Capital Gains (Current Law: Yes)	Yes	Yes	Partial
Mortgage Revenue Bonds (Current Law: Yes)	No	No	No
Builder Bonds (Installment Sale)	Limited	Yes	Yes
Special Incentives for Thrifts to Invest in Mortgages (Current Law: Yes)	No	No	No

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* Treasury would limit personal interest deductions for other than mortgages on the principal residence to $5,000 plus net investment income. Bradley-Gephardt would limit such deductions to just net investment income, but would exempt vacation homes.

** All deductions under Kemp-Kasten have a 24% marginal tax rate applied to them.

*** Most deductions under Bradley-Gephardt have only a 14% tax rate applied to them. Mortgage interest can be used to offset any net investment income (which would be taxable at higher rates). Beyond this, all such interest is deductible only at the 14% rate.

Homeownership Cost

Exhibit 2 shows an estimate of the total net cost of homeownership, on a monthly basis, for a typical recent homebuyer with an adjusted gross income of $40,000. Total homeownership cost includes not only out-of-pocket expenses such as mortgage interest, real estate taxes and maintenance, but also foregone interest on invested equity and the cost of ultimately selling the house. The net cost is derived by subtracting expected appreciation and tax savings from total cash costs of ownership.

The tax reform proposals are assumed to affect only the tax savings from homeownership. Considering only the changes in tax rates, exemptions and deductions -- and assuming no change in interest rates or house prices -- these savings drop from $257 per month under current law to $197 under Kemp-Kasten, $98 under Bradley-Gephardt, and $117 under the Treasury Department proposal. These declines in tax savings translate into increases in overall homeownership cost of 9%, 24% and 21%, respectively, under Kemp-Kasten, Bradley-Gephardt, and Treasury Department.

The increase in homeownership cost does not necessarily mean that households would pay more taxes. A household with the characteristics assumed for this example actually would pay lower taxes, in total, under all three proposals, so that the household's disposable income would increase. The increases in after-tax homeownership costs do mean, however, that the cost of owner-occupied housing would rise compared to the

EXHIBIT 2

Monthly Net Homeownership Costs
($40,000 AGI, $83,500 House, 90% LTV)

CURRENT LAW

Mortgage Interest (at 13%)	$ 814
+ Forgone Interest on Equity	111
+ Property Taxes	90
+ Util., Maint., Insurance	264
+ Brokerage Fees (Amortized)	70
Cash Costs	1,350
- Expected Appreciation (at 6%)	- 418
	932
- Tax Savings	- 257
Expected Net Cost	$ 675

	TAX SAVINGS	EXPECTED NET COST
KEMP-KASTEN	$ 197	$ 735
BRADLEY-GEPHARDT	$ 98	$ 834
TREASURY	$ 117	$ 815

Note: Property taxes, utilities and maintenance expenses are based on the average for new houses with FHA-insured mortgages. Tax savings assume that the household is married, filing jointly, that it is claiming personal deductions typical for a household in this income range and that, if the household were not a homeowner, it would be reporting income in its investment of the downpayment amount in some other asset.

cost of other consumer purchases. Furthermore, some households who have unusually high housing deductions may see their total taxes rise. For example, first-time homebuyers whose housing costs are high relative to income would have a larger tax bill.

The impact of the tax proposals on homeownership costs would vary with income. Based on the NAHB homeowner computer simulation model, Exhibit 3 shows the percentage change in homeownership cost for typical households with incomes of $20,000 per year and $60,000 per year, as well as for the typical $40,000 per year household illustrated in Exhibit 2 -- considering only changes in tax rates, exemptions and deductions, and under the assumption that interest rates and house prices are unaffected by the tax change.

If interest rates were to fall, the negative impact of the tax changes on housing costs would, of course, be mitigated. For example, rates would have to fall by more than 200 basis points to fully offset the negative impacts of Treasury or Bradley-Gephardt at the $40,000 income level. Under Kemp-Kasten, a decline of 50 to 100 basis points would offset the negative effects of tax changes. As discussed below, interest rates are unlikely to fall by enough to offset the negative effects of the tax changes.

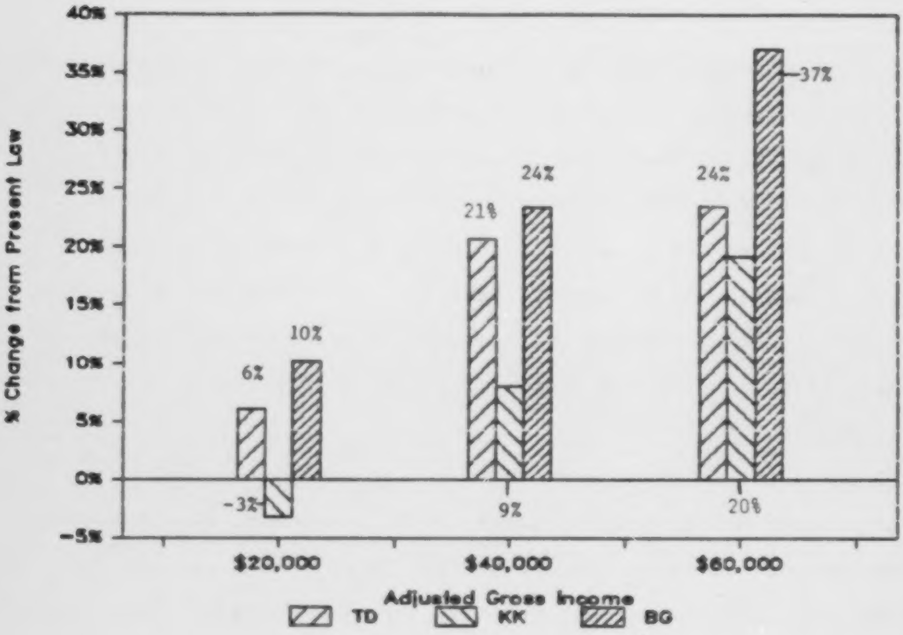
Provisions Affecting First-Time Buyers

The above estimates of impacts on homeownership costs reflect only the changes in tax rates and deductions applicable to all

EXHIBIT 3

THE IMPACTS OF TAX CHANGES ON AFTER-TAX HOMEOWNERSHIP COSTS

(assuming no change in interest rates)



Source: NAHB Simulation Model

Calculations include tax proposals regarding:

- Tax Rates
- Personal Exemptions
- Standard Deductions
- Itemized Deductions

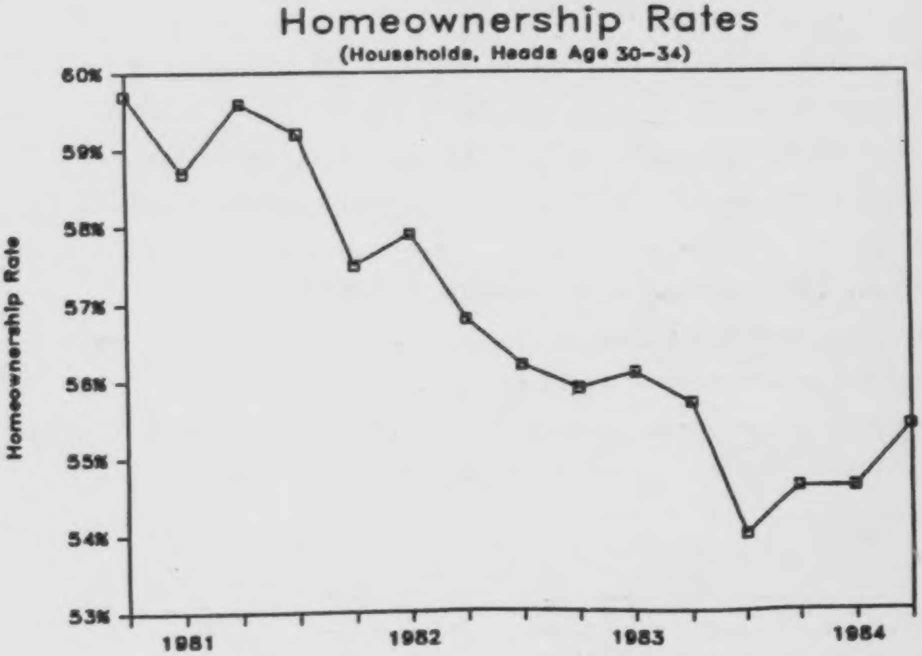
Calculations do not include proposals regarding:

- Mortgage Revenue Bonds
- Builder Bonds
- Capital Gains Treatment

homeowners. Other provisions would have particular impacts on first-time home buyers. First-time home buyers have been the primary group affected by the affordability problem associated with high mortgage interest rates. The long, steady uptrend in the U.S. homeownership rate was disrupted by high mortgage rates in the early 1980's. While homeownership among households headed by people over 40 years old was largely unaffected, younger households were significantly impacted. Exhibit 4 shows the recent trend in homeownership among households headed by people 30-34 years old.

Two major home mortgage innovations which have helped to address the affordability problem are tax-exempt Mortgage Revenue Bonds and builder bonds. All three tax reform

EXHIBIT 4



proposals would eliminate Mortgage Revenue Bonds, and Treasury would limit the use of installment sales treatment by builders -- the tax feature that has been the major factor behind the growth of builder bonds.

Loans funded by Mortgage Revenue Bonds are restricted by Federal law to first-time buyers of modestly-priced homes. In addition, the loans are targeted to economically-distressed areas, and most state and local issuers impose income limits. Mortgage Revenue Bonds have been an effective means of providing affordable financing to households who otherwise would be stymied from achieving homeownership by continuing high interest rates. The mortgage rate available to homebuyers from MRB financing is typically 200 to 250 basis points or more below market rates; thus, elimination of MRBs would raise total homeownership cost by an additional 18% to 23% for a typical household with $25,000 income buying a $52,500 house.

Builder bonds are not specifically restricted by law to moderate-income first-time buyers, but they have been used primarily by large volume builders offering FHA and VA loans, and thus have mainly benefitted such buyers. The Treasury Department proposal would severely curtail installment sales tax treatment to builders who pledge mortgages as collateral for bonds. This would curtail the development of builder financing and raise mortgage rates and/or prices to homebuyers.*

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* Some taxpayers would continue to enjoy the deferral of tax liability through installment sales treatment. Highly-liquid consumer finance subsidiaries of automobile and appliance manufacturers, whose superior access to credit markets precludes the need to pledge receivables as collateral, would still be able to use the tax break. Apparently this favorable tax treatment would also still apply to securities transactions and corporate takeovers as well.

RENTAL HOUSING

All three proposals -- but especially the Treasury proposal -would affect rental housing more severely than owner-occupied housing. The major provisions affecting rental housing are summarized in Exhibit 5.

Investors in rental housing generally are high income individuals who fall into or near the maximum personal tax bracket. Under current law, the recognition of income from investments in rental properties is deferred for tax purposes, and most rental projects actually generate tax losses in the initial years of ownership. Since these losses have been used by investors to offset other income, high marginal rates have encouraged investment in rental housing.*

The indexation of interest, which is a feature only of the Treasury proposal, could have a dramatic adverse impact on the return to investors in rental housing. Under the interest indexation provision in the Treasury proposal (from which homeowner mortgage payments would be exempt), taxable interest income as well as deductions for interest expenses would be reduced by the portion which is deemed attributable to inflation. Exhibit 6 shows the formula by which Treasury proposes to exclude a portion of interest income and expense. For example,

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* The losses in early years are offset by recognition of gains when a property is sold. However, present value considerations as well as application of capital gains rates to gains recognized at time of sale have made the current system attractive to investors in rental properties.

EXHIBIT 5

PROPOSED TAX CHANGES
AFFECTING RENTAL HOUSING

GENERAL PROVISIONS	TREASURY DEPARTMENT	KEMP-KASTEN	BRADLEY-GEPHARDT
MAXIMUM PERSONAL TAX RATE (Current Law: 50%)	35%	29%	30%
MAXIMUM CAPITAL GAINS RATE (Current Law: 20%, basis not indexed)	35%, indexed basis	17%, no indexation 29% with indexed basis	30%, no indexation
CORPORATE TAX RATE (Current Law: 46%)	33%	35%	30%
INDEX INTEREST	Yes	No	No
RENTAL HOUSING PROVISIONS			
DEPRECIATION ALLOWANCES (Current Law: ACRS, 18 yr, 175% DB)	3%/yr., Indexed Basis	About 6% of initial cost for 25 years, adjusted for inflation	6.25% per year
10 YR. AMORT. OF CONSTRUCTION PERIOD INTEREST AND TAXES (Current Law: Yes)	No	Yes	Yes
RAPID DEPRECIATION FOR LOW-INCOME REHABILITATION (Current Law: Yes)	No	No	No
TAX-EXEMPT FINANCING	Eliminate	Eliminate	Eliminate
EXEMPT REAL ESTATE FROM "AT RISK" LIMITS	No	Yes	Yes
LIMITED PARTNERSHIP PROVISIONS			
LIMIT ON LIMITED PARTNER'S INTEREST DEDUCTION	Yes	No	Yes
TREAT LARGE LIMITED PARTNERSHIP AS CORPORATION	Yes	No	No

if the inflation rate for a particular year is 7%, then 54% of actual interest expense would not be deductible. Since interest expense typically is the largest expense for investors in rental housing, the effect of such a provision could be enormous.*

EXHIBIT 6

Exclusion Rate for Interest Income and Expense
(As Proposed by the Treasury Department)

Annual Inflation Rate	Percent of Interest Excluded
0%	0%
1	14
2	25
3	33
4	40
5	45
6	50
7	54
8	57
9	60
10	62

Source: Department of the Treasury, Report to the President, v.2, p. 196.

Under current law, accelerated depreciation allowances offer a major incentive to investors, because taxes are deferred until the property is sold and the tax upon sale is primarily at reduced capital gains rates. Depreciation allowances would be reduced in the early years of the investment under all three proposals. Furthermore, capital gains would no longer be subject to a tax rate 60% below the rate applied to ordinary income.

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* The effect would, of course, be mitigated if interest indexation resulted in lower market interest rates. Interest rate effects are discussed below.

Under current law, expenses for interest and property taxes incurred during the construction period are neither deducted immediately as expenses nor added to the depreciable basis. Instead, they are separately amortized over ten years. This treatment would be continued under Bradley-Gephardt and Kemp-Kasten. Under Treasury, however, construction-period interest and taxes would be added to the depreciable basis -- a less attractive alternative from the standpoint of the investor.

Estimates of Required Rents

In order to estimate the impact of the tax proposals on rental housing, NAHB used a computer simulation model to estimate the rent that would be required to produce the same after-tax yield to investors under the provisions of current law and the various proposals. Using a set of assumptions consistent with current market conditions, the required rent for a typical unit was calculated in a manner much like that used by investors or lenders in deciding whether to finance a particular project.

Under current law, and using conventional market-rate financing, a sample unit costing approximately $38,000 to build would have to rent for $354 in order to meet the investors' yield requirements (assumed to be 8% on an after-tax, inflation-adjusted basis). Higher rents would be required to generate an equivalent after-tax yield under the three proposals, taking into account only the proposed changes in depreciation and amortization, interest deductibility (i.e., indexation under Treasury), capital gains, and marginal tax rates. The required rent under the Treasury proposal would be $502, an increase of 42%. Under Bradley-Gephardt, the required rent would be $452, an increase of 28%. The Kemp-Kasten changes would only increase required rents by 10%, to $391*. Exhibit 7 illustrates the change in required rents for projects using conventional financing with no changes in interest rates.

Tax-exempt Industrial Development Bonds have been a major source of financing for newly constructed low- and moderate-income rental housing. During 1984, such financing apparently was used for the majority of low- and moderate-income rental housing in structures with 5 or more units. Tax-exempt IDBs can reduce the interest rate on multifamily mortgages by 200 basis points or more, making it possible for investors to build projects that otherwise might not have been feasible and thus contributing to moderation in rents. All three proposals would eliminate such financing.

Taking into account elimination of tax-exempt Industrial Development Bond financing, which would be the dominant form of financing for units in the price range used in the example above, the impact on required rents would be much greater. With IDB financing, the rent necessary to provide the required 8% yield to investors under current law is only $308. The increases under Kemp-Kasten, Bradley-Gephardt and Treasury amount to 27%, 47%, and 63% respectively, as shown in Exhibit 8.

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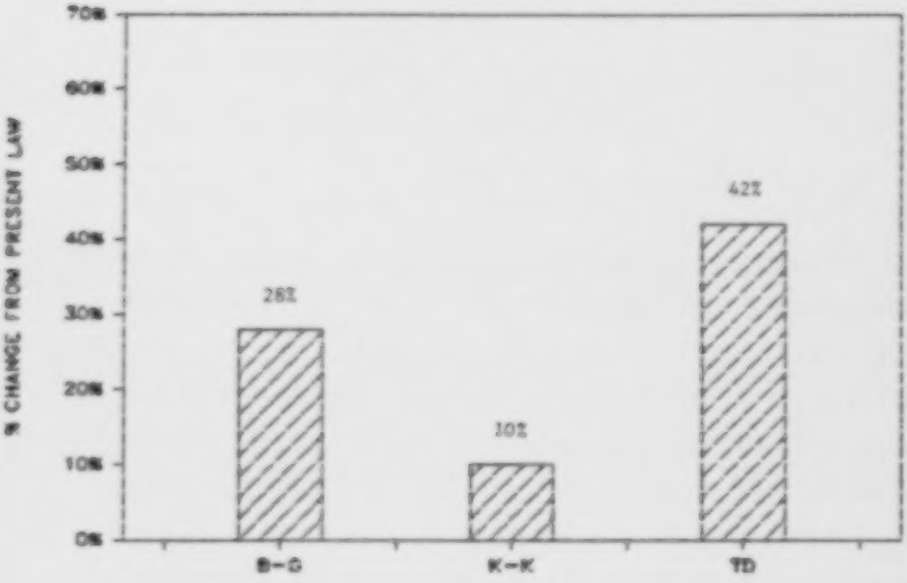
* The exact impact on required rents obviously depends on the specific set of assumptions used. In the NAHB Long Range Planning Report, the estimates of required rents were slightly different due to different assumptions about inflation rates, required yield, loan/value ratio, and construction loan rates.

EXHIBIT 7

IMPACTS OF PROPOSALS ON REQUIRED RENTS WITH CONVENTIONAL FINANCING

(assuming no decline in interest rates)



Source: NAHB Rental Simulation Model

Calculations include tax proposals regarding:

- Tax Rates
- Depreciation and Amortization
- Capital Gains
- Indexation of Interest

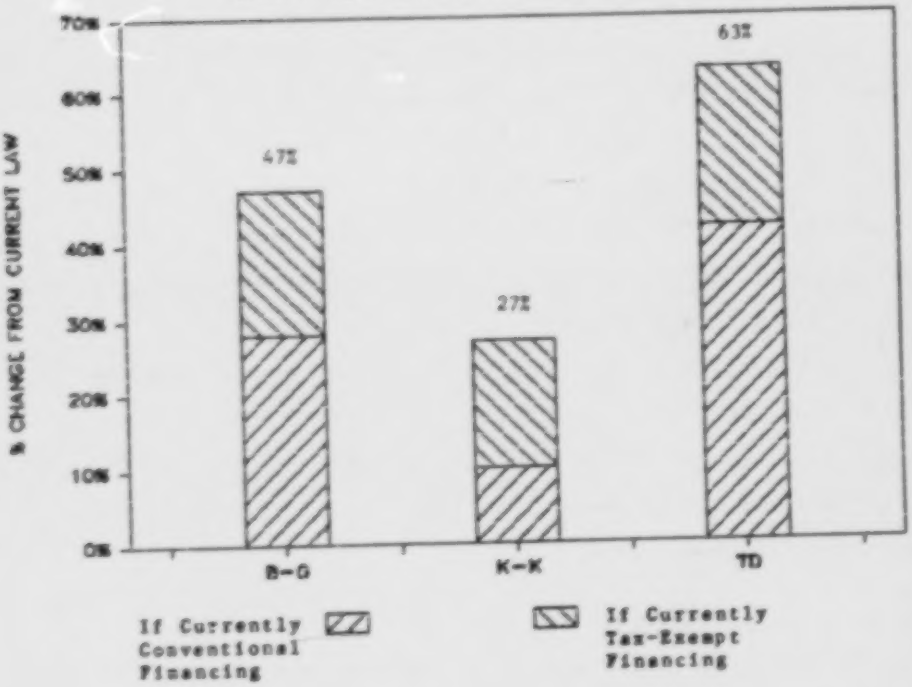
Calculations do not include proposals regarding:

- Limitation Interest Deductions
- "At Risk" Limitations
- Tax-Exempt Financing

EXHIBIT 8

IMPACTS OF PROPOSALS ON REQUIRED RENTS IF CURRENTLY TAX-EXEMPT FINANCING

(assuming no decline in interest rates)



Source: NAHB Rental Simulation Model

Calculations include tax proposals regarding:

- Tax Rates
- Depreciation and Amortization
- Capital Gains
- Indexation of Interest
- Tax-Exempt Financing

Calculations do not include proposals regarding:

- Limitation Interest Deductions
- "At Risk" Limitations

Limited Partnerships and "At Risk" Rules

The Treasury proposal not only cuts back incentives for residential investment and eliminates tax-exempt financing but also places restrictions on limited partnerships -- the primary vehicle for equity investment in rental properties. Treasury would classify interest expense from limited partnerships as "investment interest" rather than "business interest", impose a $5,000 limit on deduction of net consumer and investment interest expense, and treat groups of more than 35 limited partners as corporations. While it is difficult to quantify the likely impact of such restrictions on limited partnerships, the provisions could severely restrict the free flow of capital into housing.

The extension of "at risk" rules to real estate, included in the Treasury proposal, would force investors in real estate either to accept unlimited liability for debts of the partnership or to face reduced tax benefits. That would further discourage investment in rental housing.

The Adjustment Process

If "required" rents were to increase as a result of the adoption of one of the three tax reform proposals, the immediate result would not be a jump in rents. Since new construction accounts for only a small part of the supply of rental housing in the short run, and because of institutional factors, rents adjust to changes in costs and the volume of new construction very slowly. The immediate impact would come in the form of a virtual elimination of new construction of rental housing.*

The supply of rental housing would begin to fall as condominium conversions accelerated and abandonments increased, with no new construction to replenish the supply. As vacancy rates fell, rents would begin to increase. A resort to rent control would probably occur and exacerbate the mismatch between demand and supply. Gradually, over a period of five to ten years, rents would begin to reach the levels necessary to make new construction economically feasible under the less favorable tax environment.

Impact on Renters

To appreciate the social costs of the adjustment process and the eventual increases in rents, it is important to recognize that rental housing has become increasingly synonymous with low- or moderate-income housing. In 1983, the median income of renter households was $12,400, compared with $24,400 for homeowner households. As Exhibit 9 shows, low- and moderate-income renters are already paying very large proportions of their incomes for rent. As Exhibit 9 also shows, an increase in rents over time of 35% (less than the increase in required rents under most of the proposals compared to IDB-financed projects under current law) would make it impossible for many households to afford their current housing. As moderate income households attempted to trade down to less expensive

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* A sharp drop in the resale values of existing properties could also occur, leading to the possibility of widespread defaults on multifamily mortgages, many of which are government-insured.

EXHIBIT 9

SHARE OF INCOME SPENT ON RENT

(By Household Income)

INCOME RANGE	PERCENT OF ALL RENTERS	SHARE OF INCOME SPENT ON RENT *	
		--- CURRENTLY ---	AFTER 35% RENT ---INCREASE---
$ 0 - $ 5,000	18%	0.58	0.78
$ 5 - $10,000	21%	0.42	0.57
$ 10 - $15,000	18%	0.31	0.42
$ 15 - $20,000	13%	0.24	0.32
$ 20 - $25,000	9%	0.21	0.28
$ 25,000+	20%	0.15	0.20
All Renters	100%	0.29	0.39

Source: 1983 Annual Housing Survey, Part C

* These are the median rent burdens of the renters in each income group. Thus, half the households have higher rent burdens and half have lower burdens.

units competing with lower-income households, rents on the least-attractive, lowest-priced units could be pushed up by an even larger proportion than the average units. Some low-income households could literally be left homeless.

CONSTRUCTION ACTIVITY

It is difficult to estimate the impact of the tax proposals on new construction, since there has been no comparable major tax policy shift in the past. Exhibit 10 shows our estimate of the potential impacts of full, immediate implementation of the Treasury proposal on single-family and multifamily starts, taking into account the likelihood of a decline in interest rates of about 100 basis points. (The possibility of an interest rate decline is discussed below).

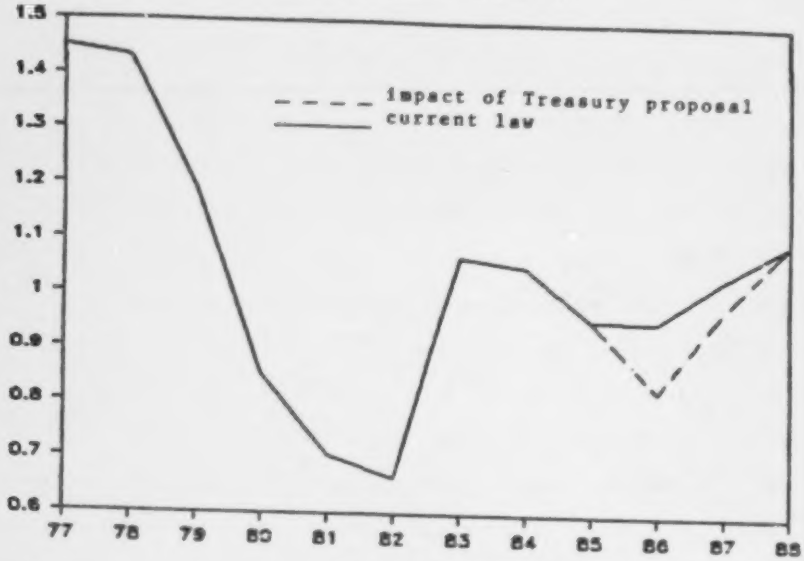
In the case of single family starts, the assumed interest rate decline partly offsets the increase in homeownership costs for the typical homeowner. However, taking into account the loss of Mortgage Revenue Bonds, restrictions on installment sale treatment of builder bonds, and a reduction in the number of vacation homes, the number of units started is likely to fall by 125,000 or about 13% in the first year. Over time, the difference between the number of starts under Treasury and the baseline forecast for current law narrows as the market for single-family homes tightens and sharply increasing rents push those renter households who can afford it to purchase homes. While the number of single-family starts is expected to converge, the average size of single-family homes is expected to be smaller under Treasury than under current law.

About two-thirds of multifamily housing units are built for rent, and virtually all new rental construction would be

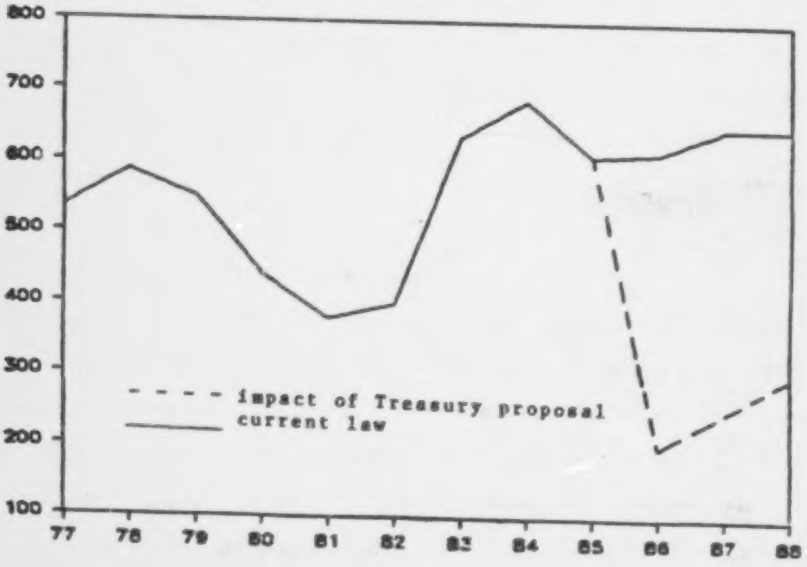
EXHIBIT 10

POTENTIAL IMPACT ON HOUSING STARTS

SINGLE FAMILY



MULTIFAMILY



eliminated under Treasury until market rents increased enough to support new construction. A large share of condominium units are also built for rent, and construction of these units would also decline -- particularly since there is likely to be an increase in conversions of existing rental units to owner-occupied condominiums. Overall, we expect that the number of multifamily starts would initially fall by 400,000, about two-thirds from the baseline projections. The recovery from that drop would be very slow, as rents gradually adjusted upward. Part of the reason why recovery in the multifamily sector is likely to be slower and less complete than in the single-family sector is that higher relative costs of housing services, generally, will cut the rate of household formations. Since new households tend to be renters, the effect would be greatest on multifamily construction.

The impact of this decline in new construction due to full, immediate implementation of the Treasury proposal would include a decline in employment of over half a million jobs. The estimated direct employment effects are shown in Exhibit 11.

Under Bradley-Gephardt, the decline in multifamily starts should be somewhat less than under Treasury but the decline in single-family starts would probably be greater. Under Kemp-Kasten, the decline in both single-family and multifamily starts should be less than under either Treasury or Bradley-Gephardt, but the effects could still be significant for multifamily -- particularly in those areas and among those types of units where tax-exempt financing is most important.

EXHIBIT 11

IMPACT ON EMPLOYMENT OF DECLINE IN CONSTRUCTION RESULTING FROM 1986 IMPLEMENTATION OF TREASURY TAX PROPOSAL

(all values in thousands)

ALL HOUSING CONSTRUCTION

	Starts	Construction Employment	Suppliers and Other Employment	Total Employment
1986	-542	-212	-355	-566
1987	-458	-163	-269	-432
1988	-350	-111	-178	-289

SINGLE FAMILY

	Starts	Construction Employment	Suppliers and Other Employment	Total Employment
1986	-127	-80	-144	-223
1987	- 58	-36	- 66	-102
1988	0	0	0	0

MULTIFAMILY

	Starts	Construction Employment	Suppliers and Other Employment	Total Employment
1986	-415	-132	-211	-343
1987	-400	-127	-203	-330
1988	-350	-111	-178	-289

Starts in thousands of units, with differences relative to forecast assuming current tax law.
"Employment" measured in thousands of man-years.
Does not include rehab. or nonresidential construction.
Assumes modest interest rate decline.
Employment effects based on data from the Bureau of Labor Statistics on employee hours per thousand dollars of construction cost.
Does not include secondary impacts caused by spending of workers and supplies or purchases of furniture, etc., by homeowners.

UNCERTAINTY AND TRANSITION

Real estate development involves very long planning horizons and creates very long-lived assets. The release of the Treasury proposal had an impact on real estate activity, as some transactions and developments were postponed or cancelled. To a large extent, this reflected overall uncertainty about future tax law changes rather than reaction to specific aspects of the proposal.

Some provisions of the proposal would change future taxation of current business deals. Moreover, some of the proposed implementation dates are close at hand, relative to the time required to organize a major development, creating the fear that less favorable depreciation and other rules would apply by the time the project is ready.

INTEREST RATE EFFECTS

The negative impacts of the tax proposals on housing would be mitigated somewhat if there were an accompanying decline in interest rates. For example, decline in interest rates of 200 basis points would offset the negative impact on most homeowners under Treasury or Bradley-Gephardt and a substantially smaller interest rate decline would offset the negative impact of Kemp-Kasten for most homeowners. In order to offset the negative effect of the Treasury proposal on rental housing, interest rates would have to fall by about 500 basis points, assuming use of conventional market-rate financing under current law; rates would have to fall by 700 basis points, assuming use of IDB financing under current law.

Sponsors of the tax proposals argue that implementation would reduce market interest rates by expanding the supply of credit and reducing borrowing. These effects on borrowing and lending are expected because both the after-tax return to lenders and the after-tax cost of borrowing would be increased by the proposals. Specifically, the proposals would reduce marginal tax rates, reduce depreciation allowances (except Kemp-Kasten) and exclude (under Treasury) portions of interest income and interest expense from taxation and deductibility, respectively. In a simplistic economic model of saving and borrowing decisions, these tax-induced shifts could reduce interest rates by as much as 300 basis points or more.

It may not be reasonable, however, to expect such substantial interest rate reductions on the basis of these tax proposals, simply because the real economic world is much more complex. The actual impact of the proposed tax changes on interest rates depends on the amount of borrowing and lending by particular suppliers or demanders of capital, the sensitivity of each of those suppliers and demanders to changes in the after-tax cost of funds or the after-tax yield, and the extent of the change in taxes or deductibility facing those sectors -- given the level of economic activity, inflation, and government borrowing. For example, many of the largest, most rate-sensitive credit market participants are either tax-exempt or would be exempt from the indexation provision.

The most important borrower -- the Federal Government -- would not borrow less as a result of the tax changes. In the household sector, most interest expense deductions (e.g., home mortgage interest and the major share of other consumer interest expense) would not be subject to indexation under Treasury. Interest on most business borrowing would be indexed, but the large portion used to finance inventories would generate additional deductions under the proposed indexation of inventory that would offset reduced interest deductions. Presumable, other business borrowing (e.g., bond financing) in fact would be reduced in response to the tax law changes.

On the supply side, the volume of overall saving is not very responsive to changes in after-tax interest rates and much of the savings in today's market are in tax-free forms (IRAs, pension funds, etc.). Moreover, foreign investors, who probably represent the source of funds most sensitive to rates, have been largely freed of U.S. tax liability, and will see any decline in pre-tax rates as a decline in after-tax rates. The major source of expansion in the supply of credit would be shifts from other assets, such as stocks or consumer durables, into credit-type assets. Such shifts would put downward pressure on interest rates.

On the basis of these and other related considerations, we estimate that interest rates could possibly fall by 100 to 150 basis points, with 200 basis points as the maximum reasonable estimate of decline under the Treasury proposal. Under Bradley-Gephardt, where there would be no interest indexation, the decline would probably be about half as large.

Under Kemp-Kasten, with its generous investment incentives, the decline would be even less. In all cases, the potential declines must be viewed as highly uncertain.

These estimates of the impact on interest rates assume that the tax proposals are revenue neutral (no impact on government borrowing), and that the proposals do not affect the general level of economic activity or the rate of inflation in the economy. While all three proposals are advertised as being revenue neutral, there is a strong possibility that they would actually lose revenue, increase the Federal deficit, and therefore increase interest rates. Also, as discussed further below, the tax changes would probably contribute to inflation, at least as measured by the CPI and GNP deflator. On the other hand, the short-term disruptive effects of the introduction of the changes, and the lack of investment incentives in the Treasury and Bradley-Gephardt proposals, suggest a decline in the level of economic activity -- an effective but unattractive means by which to achieve a decline in interest rates.*

PROPERTY VALUES

The increase in homeownership costs which would occur under the tax proposals would have a negative impact on the value of existing homes, and the prices of higher-priced houses would fall more than the prices of more modest units.

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* This discussion assumes that the Federal Reserve does not adjust monetary policy to offset impacts of tax changes on economic activity and inflation.

However, the price declines are not likely to be dramatic. The impact of the tax changes on homeownership costs would not be nearly as severe as the extremely high mortgage interest rates in 1981, yet house prices in that period fell only about 5% in real terms. Even taking account of the fact that house prices in 1981 and 1982 were overstated due to the distortions caused by the use of creative financing, the real decline then was less than 10%.

The values of rental properties would be affected more by the tax proposals than would the prices of homeowner units because the tax changes would have large negative impacts on rates of return on investment in rental housing. The extent of the decline in values will depend on investor expectations about future rents. If investors do not expect extraordinary rent increases within a short period of time, values may fall by one-third or more. If, however, investors anticipate large rent increases in the near future, the decline in values may be much smaller.

IMPACT ON INFLATION

About 20% of the Consumer Price Index is based on residential rents. Rents are used to measure the cost of housing services both for renters and for homeowners. If rents increase by anywhere near as much as our analysis suggests, there would be a substantial effect on overall inflation as measured by The CPI.

Because many wage contracts, pension payments and other prices and payments are tied to the CPI, there would be indirect feedback effects which would amplify any direct impacts of higher rents on inflation. Also, under the Treasury indexation plan, an increase in the CPI would reduce tax liabilities and increase the deficit.

While the impact of higher rents on inflation is perhaps the most readily identifiable inflationary element in the Treasury proposal, the inflationary effects probably would be general. The proposal attempts to reduce individual taxes while raising business taxes. A portion of these business tax increases would be passed on to consumers in the form of higher prices.

Chairman **LaFalce**. Before we go on to Mr. Carter, I will recognize the distinguished ranking minority member of the subcommittee, Representative Shumway.

STATEMENT OF HON. NORMAN D. SHUMWAY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. **Shumway**. Thank you, Mr. Chairman. I am delighted to be here. I appreciate your convening this hearing on this very important subject, and the witnesses being here. I would ask at this time unanimous consent that my introductory statement be included in the record. I would simply like to say, because I have a couple of committee meetings at the same hour, which have a claim upon me and my time at this moment, I'm going to have to excuse myself. But I certainly don't want that to be taken as any lack of interest in this subject matter. I think it's a very vital one. I appreciate your leadership.

Chairman **LaFalce**. Thank you very much, Mr. Shumway.

[Mr. Shumway's prepared statement follows:]

Statement of the Honorable Norman D. Shumway
April 23, 1985

Thank you, Mr. Chairman. Today, we will focus on the impact of the Treasury's tax simplification proposal on the construction and real estate industries. Perhaps, of all the changes proposed to the current tax structure, this facet undoubtedly cuts the largest swathe in the American tax fabric.

Tax reform ought to be done. Tax reform can be done. Indeed, we, as Members of Congress cannot ignore or underestimate the public demand for reform. However, I am concerned that in the process of making the rapid and radical changes to the tax code envisioned by the Treasury plan, in particular, those affecting the real estate and construction industries, we may chill -- in fact, sacrifice -- critical levels of capital investment, which are so vitally important to perpetuate this country's economic recovery, growth and competitiveness. Equally as important, we may also lose sight of the specific economic and social goals supported by these tax incentives -- the promotion of homeownership and affordable rental housing for all Americans.

I recognize that the current tax system needs to be overhauled because it has become an inefficient vehicle for spending government money. "Neutrality" and "fairness" have become the touchstones of any proposal. However, the major changes proposed for the real estate and construction industries under the Treasury plan meet neither of these standards, particularly for the individual American taxpayer. For example, elimination of the deduction of state and local taxes -- including property taxes -- not only amounts to double taxation but also may force potential homeowners out of the housing market, and tend to depress property values. Further, elimination of the tax-exempt financing provisions would raise significantly the costs of renting. Unfortunately, the proposed reduction in individuals' tax rates will not offset these increases. How can we label these changes fair and neutral?

On the corporate side of the issue, I am concerned that major wholesale changes slated in the areas of interest indexation, depreciation allowances, capital gains and treatment of limited partnerships will have a dampening effect on capital investment in the residential and commercial real estate industry. We cannot overlook the fact that this industry is one of the cornerstones of our economy, in terms of both investment and employment.

Given these results, I don't believe the Treasury plan is either neutral or fair to the real estate industry, not only because it is counterproductive to increased capital formation but also because it requires this sector to bear a greater burden of the reform. Certainly a euphoria for big changes in the tax code surrounds Congress. But let us not overlook the fact that it is better to make small steps in the right direction, steps that will not be counter-productive to our economy if the underpinning of all this is economic growth, jobs and opportunity.

Chairman LaFalce. Now we will hear from an individual who is extremely popular in my own congressional district in western New York, Billy Carter. The reason I make that statement is in 1980 I was in a parade in Niagara County. As I was marching in the parade, virtually everybody was asking me questions as I walked by—this was in September 1980—"Who are you for? Reagan or Carter?" I said, "Well, Carter, of course." And then they'd all boo. And then I'd say, "Billy Carter." And they'd go "Yea."

So the very popular Billy Carter.

Mr. Carter. Mr. Chairman, as you might suspect, I've had to give up drinking beer and eating peanuts. [Laughter.]

STATEMENT OF BILLY R. CARTER, VICE PRESIDENT OF FINANCE, NELLO L. TEER CO., DURHAM, NC, REPRESENTING ASSOCIATED GENERAL CONTRACTORS OF AMERICA [AGC]

Mr. Carter. I am pleased to be here and I represent the Associated General Contractors of America, as chairman of the AGC's Tax and Fiscal Affairs Committee.

AGC represents more than 32,000 firms, including 8,400 of America's leading general contractors, that perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal facilities. We employ nearly 3.5 million employees. We appreciate the opportunity to present comments on this subject of national tax policy.

As you mentioned in your opening remarks, my complete statement has been supplied to the committee. I will address a couple of important issues.

The Treasury Department report to the President on Tax Reform for Fairness, Simplicity and Economic Growth contains proposals that, if enacted, would have a severe detrimental impact on the entire construction industry and the general economy.

The proposals relating to income measurement or multiperiod production—that is, long-term contract accounting—resurrect an issue that predates the income tax law itself. The completed contract method of accounting for long-term contracts has been used by the construction industry since before the income tax law was imposed in 1916. It has been confirmed by regulation and legislation. Its application was extended to manufacturers in 1976, and elaborate rules were adopted for treatment of certain types of indirect expenses that had previously been treated as annual costs.

These costs were now to be deferred until contract completion along with all direct costs. In 1982, Congress addressed this issue during its review of the tax policy before passing the Tax Equity and Fiscal Responsibility Act of 1982. TEFRA provides that the 1976 regulations can be used by virtually all construction contractors, specifically contractors with an annual volume of less than $25 million and for all contracts that are completed in less than 3 years.

Treasury's proposal would eliminate these exemptions. The completed contract method of accounting for income taxes is essential to the construction industry. It permits a construction contractor who is subject to all the risks of building to build one model of a unique product, and is exposed to the risks of weather, labor, materials and supplies—and completion to the satisfaction of the owner at which time, and only at that time, can he determine the amount of his profit and pay his taxes.

Treasury would have contractors pay taxes on speculative profits and at a time when any profit that may ultimately be realized is tied up and being held by the owner as retainage. Such a measure would devastate many small and medium contractors and would make beginning new businesses, particularly for minority-owned business, extremely difficult if not impossible; primarily because contractors would then have to borrow funds with which to pay their taxes.

We find the present law workable and it permits a contractor to pay his taxes when all events have occurred, that enable the determination of the amount of profits earned. We urge Congress to not rehash the issue that was handled completely in 1982.

Another area that has recently been reviewed and dealt with by Congress is capital cost recovery. Depreciation. The accelerated cost recovery system, ACRS, was adopted in the Economic Recovery Act of 1981. In the name of fairness and simplicity, Treasury proposes to replace ACRS with a system that takes a Ph.D. in economics to figure out, much less understand.

The system would extend the recovery period for construction equipment from its present 5 years to 12 years. We do good to have some equipment last for 5 years. There is no way that the true economic life can be extended to 12 years. Contractors will be depreciating equipment long after the equipment itself has been consigned to the junk heap and replaced by new and more economical equipment.

The structure recovery period would be extended from 18 to 63 years. Even if an investor was willing to wait 63 years to recover his costs, there is no practical way for him to calculate annual depreciation and cash-flow upon which to base his investment decision.

This proposal, if adopted, would stifle new construction, reduce capital formation and completely reverse the economic recovery that was started with the enactment of RCRS. ACRS made sense in 1981 and it makes infinitely more sense in 1985.

Tax simplicity does not require that the tax law be made so complicated and confusing that no one can realistically make investment decisions.

Tax fairness does not dictate that the risk and cost of long-term capital investment be ignored.

My complete statement touches on several of the items listed by the chairman in his opening remarks and will include the retention of cash basis accounting, certain international tax accounting issues, use of municipal bonds, preservation of the present method of taxing capital gains, and several other issues.

I sincerely urge that the members of this committee read the full comments and resist all efforts to pass proposals that will in the short term and the long run not only not increase tax revenues, but will cause decreased revenues because of their smothering impact on investments, capital spending, construction and other areas of the economy.

We need to get on with rebuilding America's infrastructure and capital base. I believe that tax fairness simplicity and economic growth compels Congress to reject the Treasury proposals in these areas because they are neither fair nor simple, and will stop economic growth.

Thank you.

Chairman **LaFalce**. Thank you very much, Mr. Carter.

[The prepared statement of Mr. Carter, on behalf of the Associated General Contractors of America, follows:]

Testimony of

Billy R. Carter

for

The Associated General Contractors of America

Presented to

The House Banking Subcommittee

On Economic Stabilization

on the Topic of

National Tax Policy

April 23, 1985

SKILL RESPONSIBILITY INTEGRITY

AGC is:

- More than 32,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
- 110 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities;
- Over $100 billion of construction volume annually.

Thank you. My name is Billy R. Carter and I am here today representing the Associated General Contractors of America. AGC represents more than 32,000 firms, including 8,400 of America's leading general contracting companies. These member firms perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. We appreciate the opportunity to present testimony on the important topic of national income tax policy.

My testimony today will primarily address the Treasury Department's report to the President on "Tax Reform for Fairness, Simplicity, and Economic Growth. Although different, the Bradley-Gephardt and Kemp Kasten proposals follow a similar policy of reducing marginal rates at the expense of capital formation provisions of the Internal Revenue Code and our views of these proposals roughly parallel those of the Treasury Report.

The impact of the Treasury Department proposals on the construction industry would be severe. Owners of structures would be subject to significantly higher taxes on their investments. Increased taxes would increase the cost of all structures. New construction starts would be expected to significantly decline. In addition to raising taxes on real estate investments, the Treasury proposal would also restrict the methods used to syndicate real estate developments. Construction contractors would also be subject to revised accounting procedures under new income measurement rules which, in proposed form, do not vary in substance from theories already rejected by Congress.

The general policy thrust of the Treasury Report can be described as "tax neutrality", meaning that the Code should not recognize differences between different types of economic activities. This is a reversal of the traditional orientation of the Code which recognizes different types of economic activities. The major distinction between activities is based on the difference between capital investment and ordinary transactions. The proposed elimination of this fundamental principle is to be implemented by revising virtually every tax provision involving capital investments. In exchange for eliminating these provisions marginal tax rates would be lowered for both corporations and individuals.

AGC believes that the theory of tax neutrality is not an acceptable policy basis for developing a system to tax income. Capital investments are inherently different than transactions in the ordinary course of doing business. Capital investments in the national economy are crucial to the continued economic health of the nation. Increasing taxes on these fundamental investment activities will lead to a smaller capital base for the national economy and result in a weakened national infrastructure.

AGC's objections to the Treasury proposal are best illustrated by reviewing the major individual provisions of the report affecting construction contractors and the markets in which they do business.

Proposals

Income Measurement for Multiperiod Production - An issue of critical concern to the construction industry is the proposal to revise the completed contract method of accounting. The Treasury proposes to establish a single set of period cost capitalization rules for taxpayers reporting income from long-term contracts, self-constructing assets, certain agricultural production activities, and manufacturing inventories. The completed contract method was thoroughly reviewed by Congress in 1982 and specific statutory rules were developed to administer the accounting method in the Tax Equity and Fiscal Responsibility Act (TEFRA). The TEFRA provisions confirmed the use of the completed contract method of accounting as used in the construction industry with virtually no change. Significant revisions to the accounting method were made as they apply to multiperiod production contracts such as contracts for missiles and airplanes. Despite the detailed policy review in 1982 the Treasury has re-proposed elements of its earlier recommendations under the newly created theory of tax neutrality. AGC recommends that this Congress reject this proposal as the preceding Congress did in 1982.

The completed contract method was revised at the regulatory level in 1976 when manufacturing contracts were added to eligibility status for the method. Construction contractors have been eligible to use the method since the inception of the U.S. income tax in 1916. The accounting method is based on the fundamental tax principal known as the all events test. This test requires that a taxpayer recognize a gain or loss from a contract after all events required under the contract are performed so as to establish the taxpayer's claim to gain or loss.

The regulations published in 1976 were based on 54 years of IRS experience in administering the accounting method in construction. Cost accounting rules included in the regulations reflect tax policy and accounting principles for determining which costs are allocable to a contract. The use of these cost accounting rules was approved by Congress for virtually all construction contractors in 1982 -- all construction contractors with annual gross receipts of less than $25 million can use the 1976 rules, and any construction contract lasting less than 36 months is accounted for by using the 1976 rules. Manufacturing contracts were distinguished by Congress and use these rules for contracts lasting less than 24 months. New severing and aggregating rules were developed to restrict multi-unit contract extensions when additional units are added to the contract by change orders.

TEFRA allowed the IRS to publish revised cost accounting rules for contracts of exceptional duration called extended-period long-term contracts. In construction these rules are only applicable to contracts lasting more than 36 months. It is these rules which the Treasury originally proposed to apply to all contracts in 1976 and is re-proposing now as part of its neutrality theory. AGC opposes this proposal. Congress has already rejected the neutrality theory as it applies to manufacturing and construction contracts in TEFRA by providing sound administrative rules based on contract duration and taxpayer size, and should again reject the Treasury Department's proposal.

Capital Consumption Allowances - The Treasury proposal would replace the Accelerated Cost Recovery System (ACRS) and Investment Tax Credit (ITC) with the Real Cost Recovery System (RCRS). The new system would replace the three basic ACRS depreciation periods (3, 5, and 18 years) with seven periods ranging from 5 to 63 yers. RCRS would provide a declining balance depreciation method and an inflation adjustment to the unrecovered basis (cost) of the asset being depreciated. The percentage of basis depreciated annually varies from 32 percent for 5 year property to 3 percent for 63 year property.

RCRS replaces all investment tax credits, including the rehabilitation tax credit, and the present ACRS system. Since RCRS requires significantly longer periods to recover capital investment amounts than ACRS, there is no replacement for the investment tax credit. Depreciation under RCRS is chacterized as "economic" and reverses the fundamental principle of accelerated cost recovery embodied in the ITC and ACRS provisions enacted in the Economic Recovery Tax Act of 1981.

The 1981 Act emphasized a policy recognizing the importance of accelerated capital recovery periods. Capital asset costs are recovered faster under ACRS/ITC than the mere useful life of an asset. This policy regarding capital investment recovery was based on recognition that capital assets are a crucial factor in expanding the overall economy and that continued recapitalization is required before physical obsolence of assets occurs. The wisdom of this policy is being demonstrated today with the ongoing expansion of the economy.

The RCRS depreciation schedule requires a substantially longer period of time to recover capital costs, unless inflation substantially exceeds present levels. The RCRS structure depreciation period of 63 years would provide the smallest annual deduction for depreciation in the first year. As a result, capital investment in structures must wait longer to recover costs both in time and amounts, reversing the present ACRS structure of larger annual deductions early in a shorter recovery period. This policy would increase the cost of investing in real estate by requiring longer investment periods before the recognition of the capital investment depreciation by the taxpayer.

The RCRS system would also affect construction contractor's depreciation methods for their equipment. The RCRS treatment of construction equipment illustrates the inadequacies of the economic depreciation scheme. Construction equipment, under the RCRS systems, would be depreciated over a 12 year period at 24 percent of adjusted basis. Most types of construction equipment do not even have a useful life of 12 years. As a result, contractors will be required to wait until after the equipment's useful life to recover their investment costs. Similarily, trucks would be depreciated over 8 years, which frequently exceeds the useful life of trucks used in the construction industry.

A serious conceptual ommission is also made in the Treasury proposal concerning depreciation. No provision is made to allow taxpayers to use a "unit of production" method of depreciation as allowed under present law. This method allows a taxpayer to depreciate an asset as it is "used up" or physically wasted, if such occurs over a shorter period than is provided by the depreciation schedule. This method matches economic depreciation in any normal understanding of the concept and the ommission is a serious failing in the integrity of the Treasury proposal.

Cash Method of Accounting - The Treasury report proposes to prohibit the use of the cash method of accounting with respect to a trade or business unless both of the following conditions are met:

(1) the business has average annual gross receipts of $5 million or less; and,

(2) no other method of accounting has been used to determine income, profit, or loss of the business for the purpose of reports or statements, or for credit purposes.

Although the completed contract method of accounting is the dominant method used in the construction industry, cash accounting is also used. For example, engineering and architectural contracts are not eligible for completed contract reporting. Small construction firms (exceeding the $5 million annual gross-receipts limit) use the method as an election for all accounting purposes. The cash method is a fundamental accounting method and a necessity and must be retained.

Municipal Bonds - The Treasury report proposes to eliminate the tax exempt status of interest earned on bonds issued by state and local governments for "private purposes". These bonds are typically used to finance housing, commercial and industrial development activities within the bond issuing jurisdiction. Annual volume limits are already imposed on these bonds which are an important tool in the financing required for our national infrastructure needs. Any further restrictions on the issuance of such bonds, such as the elimination of tax exempt interest, are not necessary and will result in the long-term deterioration of the national infrastructure.

International Tax Issues - The Treasury report contains two provisions of significant concern to international construction contractors. The first concerns the reimposition of the per country limitation rule on the foreign tax credit. Construction contractors compete in countries where they are able to win contracts, the location of job sites cannot be chosen for tax planning purposes and any restrictions on offsets for taxes paid in these countries is not justified.

Construction would also be severely restricted in U.S possessions if the possessions tax credit is repealed. The credit has been most frequently used for projects built in Puerto Rico. The replacement of the credit with a temporary wage credit is not a satisfactory alternative and will lead to a decline in development in U.S. possessions, particularly in Puerto Rico.

Estate and Gift Taxes - AGC supports proposals which ease the tax burden on estates with ongoing closely- held businesses following the death of a controlling principal. The Treasury report proposes to increase tax liabilities on gifts and to eliminate the special 4 percent interest rate for installment payments of estate taxes when a closely-held business composes a significant portion of the estate. Both of these proposals will make the transfer of active business enterprises more difficult and should be rejected.

Fringe Benefits - The Treasury report proposes to repeal the statutory fringe benefit exclusions for most types of fringe benefits and restricts maximum contributions for employer provided health care. The present fringe benefit rules allow employers to structure fringe benefit packages suitable to the employees' needs and have been of significant benefit to the nation. AGC recommends the continuation of the present fringe benefit rules because of their record of success in providing needed benefits at market determined prices.

Deductibility of State and Local Taxes - The Treasury report proposes to eliminate the itemized deduction for state and local taxes that are not incurred in carrying on a trade or business. These taxes include real and personal property taxes, income taxes and general sales taxes. The report states that the elimination of the deduction is necessary to eliminate any "subsidy" for local public services such as public education, road construction and repair, and sanitary services. AGC believes the deduction for state and local taxes is based on sound policy considerations. The deduction prevents taxpayers from being taxed on taxes.

Capital Gains - The Treasury report proposes to repeal the long-term capital gains exclusion as part of the tax neutrality theory. Presently, the maximum corporate tax rate of 46 percent is reduced to only 28 percent on a net capital gain if the liability resulting from the lower rate is lower than the corporation's regular tax. For individuals and other non-corporate taxpayers 40 percent of a long-term capital is included in income (and taxed at ordinary rates). The basis of the asset would be indexed for inflation during the holding period of the asset.

The capital gain exclusion has traditionally recognized the risk of long-term investments and its retention is an important element in the fair tax treatment of long-term investments. Taxing the income generated by the disposal of long-term capital assets at ordinary rates fails to recognize the risks associated with such investments. While indexing the basis of the capital asset alleviates some of the harshness of the rule, indexing is not a suitable alternative to the present exclusion. The present exclusion recognizes that capital transactions should be taxed at different rates because of the risks associated with investments, inflation is only one risk factor.

Interest Expenses and Income - The Treasury report proposes to limit all personal interest deductions, except for mortgage interest deductions for a principal residence, to $5,000 per year over investment income. Interest subject to the investment interest limitation includes (a) all interest not incurred in connection with a trade or business, (b) the taxpayer's share of all interest expense of Subchapter S corporations unless the taxpayer actively participates in the corporation, and (c) the taxpayer's distributive share of interest expense from limited partnerships.

Limiting interest expense deductions will prevent many taxpayers from investing in long-term capital projects even though the expense incurred is clearly related to an income producing activity. A distinction between taxpayers based on existing income is inequitable because it does not provide the same tax treatment for identical investment activities.

The Treasury report also proposes to index both business and personal interest (income and expense) for tax purposes.

A fractional amount of interest income would be excluded from income while a deduction for a corresponding fraction of interest expense would not be allowed. This dramatic change in the tax treatment of interest expense and income is difficult to assess. The rule, however, favors lenders by excluding a portion of interest income with a corresponding negative treatment for borrowers and consequently will restrict capital raising activities.

Limited Partnership Restrictions - The Treasury report proposes to tax limited partnerships with more than 35 partners as corporations. Limited partnerships afford investors an opportunity to limit their risk on a partnership activity to their contributed investment, provided they do not participate in the management of the partnership. The limited partnership mode of doing business is well established in the common law. There is no justification for its elimination. Without this type of investment vehicle, many investors will find it difficult to participate in an investment as owners.

Extension of the At-Risk Limitations - The Treasury proposal would impose restrictions on non-recourse financing used in real estate developments. The code's "at risk rules" have never applied to real estate syndication (or certain equipment leasing transactions) and provide flexibility in developing financing arrangements where significant physical assets exist. No specific real estate abuses of valuation are identified as a reason for proposing this change.

Corporate Tax Rates - Although the Treasury report has been widely promoted as reducing the maximum corporate rate of tax from 46 percent to 35 percent, the report also recommends that many corporate tax rates be increased. Corporate tax rates have been partially graduated since 1935. The present maximum corporate tax rate of 46 percent only applies to corporations with annual incomes in excess of $140,500. Rates of 15, 18, 30 and 40 percent are available for corporations making less than $100,000 annually. These rates for lower income corporations allow smaller firms to generate needed capital by retaining income in the corporation at the lower corporate rates and should be retained.

Summary

AGC is opposed to eliminating the capital recognition provisions of the Code as proposed by the Treasury Department.

o Private sector construction activities will decline as a result of the elimination of ACRS, ITCs, capital gains, and restrictions on investment vehicles.

o Public sector construction activities will also decline because of the elimination of tax-exempt bond financing and the deduction for state and local taxes.

o Construction companies will also be adversely affected by proposed changes to the completed contract method of accounting which have already been rejected by Congress as unnecessary.

AGC recommends retaining present law and continued regular review of the code to assure ongoing policy justification of provisions and to assure adequate compliance in lieu of proposals such as the Treasury Department's Report.

Chairman **LaFalce**. Our next witness will be Patric Hendershott of Ohio State University and the National Bureau of Economic Research.

STATEMENT OF PATRIC H. HENDERSHOTT, GALBREATH PROFESSOR OF REAL ESTATE, OHIO STATE UNIVERSITY; RESEARCH ASSOCIATE OF THE NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. **Hendershott**. Thank you, Mr. Chairman, for inviting me to speak this morning on the important topic of tax reform and its implications for real estate. I am tempted to say that I represent truth and honesty but having been in academe for many years, I couldn't make that statement with a straight face.

While my full, written statement deals solely with the Treasury reform proposal, this oral report refers to all three of the leading reform proposals, Bradley-Gephardt, Kemp-Kasten, and the Treasury plan.

I do this for two reasons. First, the Treasury plan is obviously undergoing revision at this very moment. It may well take on features of the other proposals.

Second, the basic analytical principals involved are best understood in a broader context than a single reform proposal.

Revenue neutral tax reforms affect real estate investment and returns indirectly via changes in interest rates as well as directly through changes in various tax deductions.

Just because a tax reform is revenue neutral does not mean that it is interest rate neutral. Different reforms may well have significantly different effects on interest rates. In fact, I anticipate that interest rates would decline markedly if the Treasury plan were enacted, significantly; if Bradley-Gephardt were passed, and hardly at all in response to Kemp-Kasten.

Moreover, knowing the differential impacts of these reform proposals on interest rates leads to quite misleading assessments over their relative effects on real estate activity.

To illustrate, the direct effect of Bradley-Gephardt on real estate is far more negative than that of Kemp-Kasten, but after allowance for differential impacts on interest rates, I estimate the total effects on real estate of these two proposals to be remarkably similar.

Also, while the direct effect of the Treasury plan on single-family housing is negative, the Treasury plan turns out to have a positive impact on such housing when my estimated interest rates decline is incorporated.

IMPACT OF TAX REFORMS ON INTEREST RATES

Let's examine the interest rate impacts of the reform proposals more closely. The level of interest rates in an economy reflects both what borrowers are willing to pay to finance real investments and what lenders are willing to accept.

The key provision in the Treasury plan for interest rates is indexation of interest income and expense for inflation. Under this plan only the real component of interest would be taxed and could be deducted, and at a 6-percent inflation rate, the real component would be only half of the total interest.

With reduced deductibility, borrowers will not be willing to pay as high an interest rate as before, and with lesser taxation, lenders will be willing to accept a lower one. Thus interest rates will decline.

Consider the following example: Say that borrowers are willing to pay after-tax interest of 6 percent and lenders are willing to accept 6 percent after tax. If both are in the 50 percent tax bracket, the level of pretax interest rates will be 12 percent. That is, with the Government paying half of the 12 percent for borrowers and taking half from lenders, their after-tax costs in return will be the required 6 percent.

If indexation is introduced, and only half the interest is taxed and deducted, pretax interest rates will drop all the way from 12 percent to 8 percent. Only with this 4-percentage-point decline will borrowers still be paying 6 percent after tax—the Government now pays only 2 percent; that is, they pay half of the half of 8 percent—and only if the rates declined to 8 percent would lenders still be getting their 6 percent. The 4-percentage-point decline occurs without any change in saving and investing or in borrowing or lending. The decline results solely from the Government reducing the wedge it places between pretax and post-tax interest rates.

Interest indexation is not the only tax reform provision of importance to interest rates. Let me refer briefly to the Bradley-Gephardt plan to illustrate this point.

Bradley-Gephardt could be categorized as antiinvestment. Relative to current law, depreciation tax write-offs would be less—6 percent in the first year for real estate properties versus the current 10 percent—capital gains taxation will be heavier—30 percent versus the current 20 percent or less; the tax of which real estate expenses are deductible would be lower, 30 percent versus 50 for income-producing properties, and 14 percent versus up to 50 percent for owner-occupied housing—and the investment tax credit would be, as my son likes to say, history.

At a given level of interest rates, the demand for all real capital would decline. As a result, the demand for funds and, thus, interest rates would also decline and with the decline in interest rates, Bradley-Gephardt would not be so antiinvestment after all.

Taking all provisions into account, my best estimate of the decline in interest rates in response to enactment of the Treasury plan is 2 percentage points. There is, of course, substantial uncertainty regarding the magnitude of this decline, the interest sensitivity of foreign saving being the primary source. If foreign saving were extremely interest-sensitive, only a percentage point decline might be expected. If foreign saving were insensitive, a 3½ percentage point decline would be a reasonable estimate. The assumed 2 percentage point decline lies between these two extremes.

The same analysis, I might add, leads to a 1 percentage point decline with Bradley-Gephardt and to virtually no interest rate change with Kemp-Kasten.

IMPACT OF TAX REFORMS ON DEPRECIABLE PROPERTIES AND HOUSING

My gauge of the impact of tax reform on investment in depreciable real estate is how much rents or net operating income would have to change in order for builder profit margins to be maintained and for investors to be able to earn a risk-adjusted rate of return. The more rents have to rise, the deeper and longer will the slowdown in construction activity be until the rent increase occurs.

As for the Treasury plan, the less generous depreciation allowances at inflation rates below about 12 percent and the indexation—partial deductibility—of interest expense are both significant negatives tending to raise required rents, but the 2-percentage-point decline in interest rates works in the opposite direction. On net, I estimate that rents on residential real estate will have to rise by about 20 percent, while those on commercial real estate will have to rise by about 10 percent. The smaller rise for the latter being due to the less favorable current tax depreciation of commercial property.

In contrast, the percentage rise in residential rents would be 5 percent under Bradley-Gephardt and Kemp-Kasten and commercial rents would not have to increase at all.

My gauge of the impact of tax reform on single-family or owner-occupied housing is the analog to the change in rents on rental housing. The change in the annual rental cost of obtaining housing services from owner-occupied housing is the real aftertax financing rate plus upkeep expenses. Thus, owner-occupied rents are greater the more mortgage finance costs and the lower is the tax rate at which housing expenses, interest and property taxes, are deductible.

Again, an increase in these owner-occupied rents would cause a decrease in demand and, thus, new construction, while a decrease in rents would stimulate demand and construction.

Because tax rates at which interest rates is deducted would be lower under the Treasury plan—property tax wouldn't be deductible at all—owner-occupied rents would tend to rise. However, the 2-percentage-point decline in interest rates along with the exclusion of home mortgage interest from the indexation provision would more than offset the decrease in deductions for the vast majority of households.

More specifically, for households with incomes below $30,000, the cost of owner-occupied housing would fall by 10 percent. For those with incomes between $40,000 and $70,000, the decline would be 5 percent. Only for households with adjusted gross incomes above about $90,000 would costs rise and the increase would be minor.

In contrast, under Bradley-Gephardt and Kemp-Kasten, owner-occupied rents would rise for households with incomes above about $45,000 and the increase would be a full 25 percent at the $130,000 income level.

The combination of the 10-percent decline in the cost of owner-occupied housing for households with income between $15,000 and $30,000 and the 20-percent increase in rents, would lead to a significant increase in homeownership if the Treasury plan were enacted. A modest increase, at best, would occur under Bradley-Gephardt and Kemp-Kasten.

CLOSING REMARKS

Before summarizing my results, let me briefly consider the specific impacts of two of the Treasury proposal's most novel features, interest rate indexation and the partial dividend exclusion. These most novel provisions, I understand, may very well not last to Treasury II.

Removal of interest indexation from the Treasury plan would sharply reduce the likely decline in interest rates. Without the decline in interest rates, the modified Treasury plan would raise owner-occupied rents across the board and the rents could rise at the very high income level by as much as 20 percent. That is, the Treasury plan would have a significant negative impact on single-family housing.

In contrast, removal of the indexation feature would not significantly alter the plan's impact on depreciable real estate. Higher interest rates would, of course, tend to raise required rents but the shift back to full deductibility of interest would have a roughly offsetting effect.

The partial dividend exclusion of the Treasury plan tends to raise interest rates because corporations with the added dividend deduction would be willing to pay more for funds. Removal of the dividend deduction from the Treasury package, then, would tend to lower interest rates and would stimulate all real estate activity.

Summarizing the impact of the Treasury plan on real estate is fairly easy. Any plan that introduces indexation of interest expense, that is, only partial deduction for the financing of all real investments except owner-occupied housing, is surely going to raise the homeownership rate and stimulate construction of single-family homes. The stimulus will be achieved by a significant decline in interest rates.

On the other hand, any plan that extends the depreciable write-off period to 63 years and prohibits the conversion of ordinary income to lightly taxed capital gains, will almost certainly be negative for depreciable real estate.

I thank you.

[The prepared statement of Mr. Hendershott, "Tax Reform and Real Estate," and a paper prepared with David C. Ling, "The Likely Impact of the Treasury Tax Reform Plan on Housing," follow:]

Tax Reform and Real Estate*

Patric H. Hendershott

The Ohio State University and the National Bureau of Economic Research

Thank you for inviting me to speak on the important topic of tax reform and its implications for real estate. While my full written statement deals solely with the Treasury reform proposal, this brief oral report refers to all three of the leading reform proposals: Bradley-Gephardt, Kemp-Kasten and the Treasury plan. I do this for two reasons. First, the Treasury plan is obviously undergoing revision at this very moment and may well take on features of the other proposals. Second, the basic principles involved are best understood in a broader context than a single reform proposal.

Revenue-neutral tax reforms affect real estate investment and returns indirectly via changes in interest rates, as well as directly through changes in various tax deductions. Just because a tax reform is revenue neutral does not mean it is interest-rate neutral. And different reforms may well have different effects on interest rates. In fact, I anticipate that interest rates would decline markedly if the Treasury plan were enacted, significantly if Bradley-Gephardt were passed, and hardly at all in response to Kemp-Kasten. Moreover, ignoring the differential impacts of these reform proposals on interest rates leads to quite misleading assessments of their relative effects on real estate activity. To illustrate, the direct effect of Bradley-Gephardt on real estate is far more negative than is that of Kemp-Kasten, but after making allowance for differential impacts on interest rates, I estimate the total effects on real estate of these two proposals to be remarkably similar. Also, while the direct effect of the Treasury plan on single-family housing is negative, the Treasury plan turns out to have a positive impact on such housing when my estimated interest rate decline is incorporated.

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*Testimony prepared for the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives, April 23, 1985.

Impact of Tax Reforms on Interest Rates

Let's examine the interest rate impacts of the reform proposals more closely. The level of interest rates in an economy reflects both what borrowers are willing to pay to finance real investments and what lenders are willing to accept. The key provision in the Treasury plan for interest rates is indexation of interest income and expense for inflation. Under this plan, only the "real" component of interest would be taxed and could be deducted, and at a six percent inflation rate, the real component would only be half of total interest. With indexation, borrowers will not be willing to pay as high an interest rate as before and lenders will be willing to accept a lower one. Thus interest rates will decline.

Consider the following example. Say that borrowers are willing to pay after-tax interest of 6% and lenders are willing to accept 6% after-tax. If both are in the 50% tax bracket, the level of pre-tax interest rates would be 12%. That is, with the government paying half of the 12% for borrowers and taking half from lenders, the after-tax cost and return would be 6%. If indexation is introduced and only half of interest is taxed and deducted, pretax interest rates would drop all the way from 12% to 8%. Only with this decline would borrowers still be paying 6% after-tax (the government now only pays 2% -- 50% of half of 8) and would lenders still be getting 6% after-tax.

Interest indexation is not the only tax-reform provision of importance to interest rates. Let me refer briefly to the Bradley-Gephardt plan to illustrate this point. Bradley-Gephardt could be categorized in anti-investment. Relative to current law, depreciation tax writes-offs would be less (6% in the first year for real estate properties versus the current 10%), capital gains taxation would be heavier (30% versus the current 20% or less), the tax rate at which real estate expenses are deductible would be lower (30% versus 50% for income properties and 14% versus 14% to 50% for owner-occupied housing), and the investment tax credit would be, as my son likes to say, history. At a given level of interest rates, the demand for all real capital would decline. As a result, the demand for funds and thus interest rates would also decline. And with the decline in interest rates, Bradley-Gephardt would not be so anti-investment after all.

Taking all provisions into account, my best estimate of the decline in interest rates in response to enactment of the Treasury plan is 2 percentage points. There is, of course, substantial uncertainty regarding the magnitude of this decline, the interest sensitivity of foreign saving being the primary source. If foreign saving is extremely interest sensitive, only a half percentage point decline might be expected; if foreign saving were insensitive, a 3½ percentage point decline is a reasonable estimate. The 2 percentage point decline is, of course, an average of these two extremes. The same type of analysis, I might add, leads to an one percentage point decline with Bradley-Gephardt and to virtually no change with Kemp-Kasten.

Impact on Depreciable Real Estate

My gauge of the impact of tax reform on investment in depreciable real estate is how much "rents" or net operating income would have to change in order for builder profit margins to be maintained and for investors to be able to earn a risk-adjusted market rate of return. The more rents have to rise, the deeper and longer will the slowdown in construction activity be until the rent increase occurs. The less generous depreciation allowances (at inflation rates below about 13 percent) and the indexation -- partial deductibility -- of interest expense are both significant negatives of the Treasury plan, tending to raise required rents, while the two percentage point decline in interest rates works in the opposite direction. On net, I estimate that rents on residential real estate would have to rise by 20%, while those on commercial real estate would have to rise by 10% (the smaller rise for the latter being due to the less favorable tax depreciation of commercial property under current law and the equal treatment under the Treasury plan). In contrast, the percentage rise in residential rents would be 5% under Bradley-Gephardt and Kemp-Kasten, and commercial rents would not increase at all.

My gauge of the impact of tax reform on single-family (owner-occupied) housing is the analogue to the change in rents on rental housing: the change in the annual rental cost of obtaining housing services from owner-occupied housing. Again, an increase in rents would cause a decrease in demand and thus in new construction, while a decrease in rents would stimulate demand and construction. Owner-occupied "rents" are greater the more mortgage finance costs and the lower is the tax rate at which housing expenses (interest and property taxes) are deductible. Under current law, owner-occupied rents decrease as a household's income increases because the tax rate at which housing expenses are deductible rises. (Economists and others have long questioned the wisdom of lower housing costs for higher income households than for lower income households on both equity and efficiency grounds, and all of the tax reform proposals would reduce this source of inequity and inefficiency.)

Because tax rates at which interest is deducted would be lowered under the Treasury plan (property taxes would not be deductible at all), owner-occupied rents would tend to rise. However, the two percentage point decline in interest rates more than offsets the decrease in deductions for households (family of four) with adjusted gross incomes below about $90,000 or for the vast majority of households. More specifically, for households with incomes below $30,000, the decline in the cost of owner-occupied housing is 10 percent; for those with incomes between $40,000 and $70,000 the decline is 5 percent. In contrast, under Bradley-Gephardt and Kemp-Kasten, owner-occupied rents will rise for households with incomes above about $45,000, and the increase would be 25 percent at the $130,000 income level.

The combination of the 10% decline in the cost owner-occupied housing for households with income between $15,000 and $30,000 and the 20% percent increase in the cost of rental housing would cause a significant increase in homeownership if the Treasury plan were enacted. Only a modest increase, at best, would occur under Bradley-Gephardt and Kemp-Kasten.

Removal of Specific Provisions

Before summarizing my results, let me briefly consider the specific impacts of two of the Treasury proposal's most novel features: interest indexation and the partial dividend exclusion. Removal of interest indexation from the Treasury plan would sharply reduce the likely decline in interest rates. Without the decline in interest rates, the modified Treasury plan would raise owner-occupied rents across the board; at the $130,000 level the increase would be 20%. That is, the Treasury plan would be negative for single-family (owner-occupied) housing. In contrast, removal of indexation would not significantly alter the impact on depreciable real estate. Higher interest rates would, of course, tend to raise required rents, but the shift back to full deductibility of interest would have a roughly offsetting effect.

The partial dividend exclusion of the Treasury plan tends to raise interest rates because corporations, with the added dividend deduction, would be willing to pay more for funds. Removal of the dividend deduction from the package would thus tend to lower interest rates and stimulate all real estate activity.

Summary

Summarizing the impact of the Treasury plan on real estate is fairly easy. Any plan that introduces the indexation of interest expense, i.e., only partial deduction, for interest financing of all real investments except owner-occupied housing is surely going to raise the homeownership rate and stimulate construction of single-family houses. The stimulus will be achieved by a significant decline in interest rates. On the other hand, any plan that extends the depreciable write-off period to 63 years and prohibits the conversion of ordinary income to lightly-taxed capital gains will almost certainly be negative for depreciable real estate.

The Likely Impact of the Treasury Tax Reform Plan on Housing

Patric H. Hendershott and David C. Ling[*]

The Treasury Department's "Tax Reform for Fairness, Simplicity and Economic Growth" is a comprehensive and far-reaching proposal likely to have significant impact on many economic decisions and activities. Our concern is with how enactment of the proposal would alter housing costs and thus the demands for owner-occupied and rental housing. Housing costs will be altered directly by numerous changes in both the personal income tax schedule and the tax treatment of rental housing; costs will be altered indirectly to the extent that interest rates and after-tax incomes change.

Our major conclusion is that the Treasury tax proposal will provide a strong stimulus to owner-occupied housing because it lowers the cost of such housing for low, middle and even upper middle income households. This reduction is attributable to an expected two percentage point decline in interest rates. A secondary conclusion is that rental housing demands will be restricted by a significant (roughly 20 percent) rise in rent levels. Given the decline in the cost of owning and rise in the cost of renting, homeownership should increase noticeably.

One analysis is divided into three sections and a summary. Section I computes personal tax rates (both average and those relevant to owner-occupied housing) for owners and renters at different levels of adjusted gross income under both current law and the Treasury proposal. Section II explains why interest rates should be expected to decline significantly in response to enactment of the Treasury plan. Computations of how the costs of obtaining housing services from both owner and rental housing (and their ratio) would be altered by the Treasury plan are presented in Section III. Appendix A discusses how much interest rates might decline (ignoring saving responses) if the Treasury plan were enacted, and Appendix B describes our methodology for computing housing costs.

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I. Personal Tax Rates under Current Law and the Treasury Plan

The top panel of Table 1 presents taxable income under current law and a variety of tax rates for households with adjusted gross income (AGI), assuming they rented, of 17½, 27½, 40, 70 and 130 thousand dollars. Because the choice of ownership automatically reduces a household's AGI by the interest previously earned on the funds now invested in its house, an owning household with the same resources as a renting household will have a lower AGI. To hold resources constant, we compare owning households with AGIs, assuming they rented, to renting households with the same AGIs, and average tax rates are computed as the ratio of taxes paid to AGI as renters.

Separate data are computed for renting and owning households. The calculations assume:

Table 1: Data Relevant to the Demand for Owner-Occupied Housing
Under Current Law and the Treasury Proposal

	Adjusted Gross Income				
Current Law	17,500	27,500	40,000	70,000	130,000
Renter:					
Average Tax Rate	.069	.106	.137	.203	.276
Marginal Tax Rate	.16	.18	.28	.38	.45
Owner:					
Average Tax Rate	.032	.056	.072	.095	.152
Marginal Tax Rate	.14	.16	.18	.28	.42
Tenure Choice Tax Rate	.129	.173	.230	.347	.433
Treasury Proposal	18,025	28,325	41,000	71,400	132,600
Renter:					
Average Tax Rate	.053	.090	.113	.171	.247
Marginal Tax Rate	.15	.15	.25	.25	.35
Owner:					
Average Tax Rate	.032	.063	.077	.106	.156
Marginal Tax Rate	.15	.15	.15	.25	.35
Tenure Choice Tax Rate	.080	.107	.137	.250	.350

(1) the households have the average fringe benefits and nonhousing itemized deductions of their income classes (based on 1981 Statistics of Income data),

(2) the households file jointly and claim four total exemptions, and

(3) owning households at these AGI levels purchase houses of dollar value equal to approximately twice their AGI incomes and pay property taxes equal to 1.2 percent of their house values.

(4) the mortgage rate is 13 percent, and households borrow 90 percent of the house value.

Under these assumptions owning households spend roughly 28 percent of their income on housing. These households, then, are relatively low wealth households who have recently moved and thus have the "equilibrium" level of housing. As can be seen, under current law the average tax rates quadruple (and a little more for owners) as income rises from \$17½ thousand to \$130 thousand, and marginal rates triple. For the income levels considered, the tax rate relevant to the tenure choice -- the average tax rate at which interest and property taxes are deductible -- lies between the marginal tax rates for owners and renters.

The lower portion of Table 1 provides comparable data for the Treasury plan. This plan increases adjusted gross income for households by counting some fringe benefits as income, reducing the tax deductions for charitable contributions and medical expenses, and eliminating deductions for state and local income, sales, and, most importantly from our perspective, property taxes. Based on some internal Treasury data, the AGIs for renting households are increased by three percent at the current \$17,500 and \$27,500 AGI levels, 2½ percent at \$40,000, and two percent at \$70,000 and \$130,000. On the other hand, personal deductions are raised to \$2,000, and marginal tax rates are generally lowered (the maximum from 50 to 35 percent).

The Treasury plan also includes the indexation of interest income and expense for inflation; only the "real" portion of interest is taxed and can be deducted. The Treasury would assume a real interest rate of 6% and allow the deduction (or would tax) only $6/(6 + \pi)$ of interest paid (or earned) where π is the actual inflation rate in a tax year. Thus if inflation were 6%, only half of interest would be taxed and deducted. However, mortgage interest on one's principal residence would be fully deductible.

Average tax burdens for renters would decline by roughly 15 percent (25 percent for our lowest income group and 10 percent for those with very high incomes). Low-wealth, middle-income owners, on the other hand, would face a roughly 10 percent tax increase at middle incomes due to the loss of the property tax deduction and the reduced value of interest deductions. This would not be the case for high-wealth owning households who would have an incentive to arbitrage the indexation of all interest other than home mortgage -- borrow fully deductible mortgage money and invest in partially-taxed bonds (CDs at the institutions which supplied the mortgage money?), an action that would lower their average tax rate and turn the Treasury plan into a revenue loser. A reasonable way to limit such arbitrage would be to allow indexation on only the excess of taxable interest income over interest expense.

The marginal tax rates relevant to the quantity of owner-occupied housing demanded are virtually unchanged under the Treasury plan for households with AGI (if they rented, recall) below about $30,000 and would decline by roughly a sixth for households with AGI above this amount. For renting households, the decline would begin at the $20,000 income level and would be close to a third at AGIs above $70,000. The tax rate relevant to the tenure choice -- the average tax rate at which interest only is deductible -- of lower and middle income households (AGI on renter basis below about $50,000) is below the marginal rate because a significant part of their housing deductions would be wasted (nonhousing deductions would be less than the zero bracket amount because the Treasury plan substantially reduces such deductions). For these households, the tenure choice tax rate is an average of zero and the marginal rate (15 percent).

II. The Likely Impact on Interest Rates

The level of interest rates reflects what borrowers are willing to pay to finance real investments and what lenders are willing to accept. Because higher expected inflation increases both borrower's expected nominal returns on their underlying real investments and lender's required nominal returns, increases in inflation raise the level of interest rates. How much higher the level of rates will be depends on the tax treatment of interest expense and interest income. The greater the tax saving from interest deductions (and thus borrowers' ability to pay pretax interest) and the taxation of interest income (and thus lenders' required pretax return), the higher will interest rates be. All tax reform plans will cut the marginal tax rates at which borrowers can deduct interest and at which lenders are taxed on interest. This aspect of the plans will therefore tend to lower interest rates.

A major provision contained only in the Treasury plan is the indexation of interest income and expense (except interest expense on home mortgages). As a result, the interest rates borrowers would be willing to pay and lenders would be willing to accept would be significantly reduced. The downward pressures on interest rates of indexation and lower marginal tax rates would be amplified by other features of the Treasury tax proposal, namely removal of the investment tax credit and less favorable tax treatment of depreciation. This greater taxation of real investments would further reduce the amount business borrowers will be willing to pay for money (the proposed dividend exclusion, on the other hand would tend to raise the amount corporations would be willing to pay for funds).

To illustrate the potential impact of the Treasury proposal on interest rates, we have computed the maximum interest rate that corporations could pay to finance under the Treasury proposal assuming they can pay 13 percent under current law and that the marginal product of corporate structures is unchanged. The result is roughly 9½ percent or a decline of 3½ percentage points (see Appendix B). For business equipment and real estate investment, the decline would be greater owing to the removal of the investment tax credit from the former and the greater reduction in tax depreciation on the latter. For owner-occupied housing, the decline would be less because home mortgage interest expense would not be indexed. The actual decline in rates would be mitigated to the extent that saving is reduced, and foreign savers would clearly have an incentive to provide fewer funds in response to lower returns (taxes paid by foreigners on interest would not be affected by American tax law). For this reason, we analyze only a two percentage point decline in rates, but this decline could as well be an understatement of the actual decline as an overstatement (calculations for constant rates are given to illustrate the sensitivity of the results to the assumed interest rate decline).

III. The Likely Impact on Housing Costs

To obtain the services of a capital unit such as a house for a year, one must pay for the financing and "upkeep." The financing cost is the real interest rate; upkeep includes maintenance and a charge for economic depreciation to the extent that the capital is not fully maintained. In addition, property taxes must be paid and tax savings, owing to deductions, are earned. Percentage changes in the net cost, so computed, of obtaining housing services from owner-occupied housing due to adoption of the Treasury plan are shown in Figure 1 for households at different income levels (see Appendix A for the methodology underlying these calculations).

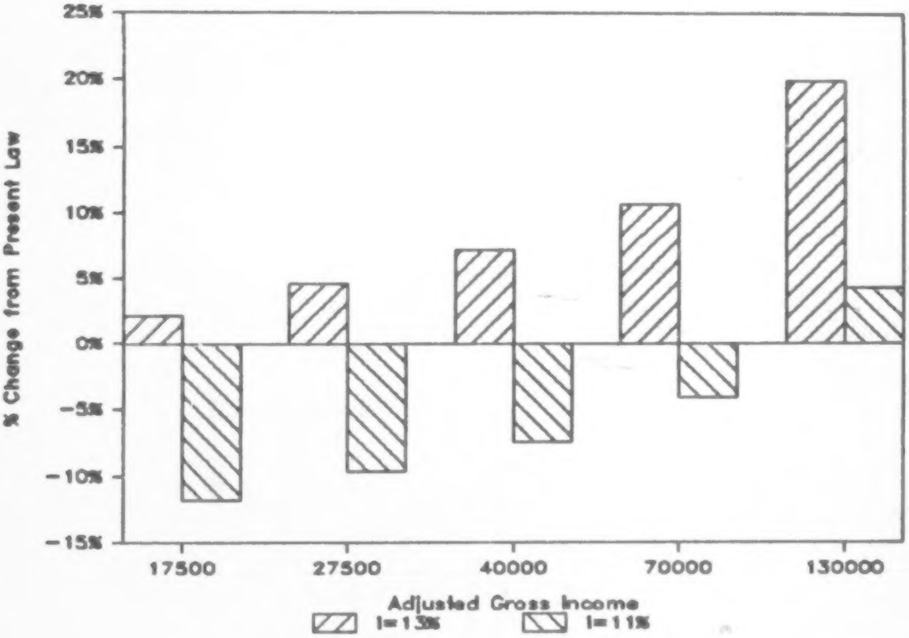
If interest rates were to remain at the current 13 percent level, costs would rise for households at all income levels and rise by a greater percentage the higher is income. The loss of the property tax deduction is important here, and the loss is, of course, more costly for those in higher tax brackets. A reinforcing factor is the decline in marginal tax rates for households with AGI above $30,000. While owner-occupied housing is a zero taxed asset (treating property taxes as cost of obtaining local services, not housing), the attractiveness of such an asset depends on one's tax bracket. A reduction in the rate at which mortgage interest is deductible raises the cost of owner-occupied housing.

In our most likely scenario, interest rates decline by two percentage points to 11 percent (rates are as likely to decline by more than this as by less). Very high income households are still affected negatively, but owning households with incomes under $75,000 AGI would experience a decline in costs of housing. More specifically, for households with AGIs under $30,000, the decline in costs is 10 percent; with AGIs between 40 and 70 thousand dollars, the decline is 5 percent. On the other hand, costs rise by 5 percent for households with AGIs between 90 and 135 thousand dollars.

The cost of obtaining housing services from rental housing is simply the rents paid. In the long run, rent levels must be sufficient to elicit new production to replace depreciated rental units and to meet the additional demand from newly-formed households. Rent levels are currently low owing to

Figure 1

Impact of Treasury Proposal on Cost of Owner-Occupied Housing



extraordinary interest and tax depreciation deductions available on rental properties. The large interest deductions follow from both high interest rates and high loan-to-value ratios. The high value of depreciation deductions stems from the front loading of ACRS (175 percent declining balance with full write off over 18 years) relative to actual economic depreciation and the low taxation of capital gains which encourages trading and thus multiple write offs of the same property. Current law also allows the amortization of construction period interest and taxes (CPIT) over ten years, provides for even more rapid depreciation on low income rental housing, permits occasional below-market tax-exempt financing, and gives special tax credits on certain rehabilitation projects.

The Treasury plan would sharply curtail all these advantages. As noted above, interest indexation allows the deduction of the real part of interest only. Tax depreciation would be reduced to 3 percent a year (although on an indexed -- replacement cost -- basis), CPIT would have to be amortized over the full economic life, and tax-exempt financing, rehabilitation tax credits and the special treatment of low income housing would all be eliminated. (The proposal would also apply at risk rules to real estate and restrict syndications, but these changes are of little import; with enactment of the other Treasury provisions, all investment would already be at risk and there would no longer be any tax losses to syndicate.) As a result, an increase in rents would be required to induce new production. With a 2 percentage point decline in interest rates, the rent increase is 19 percent (with no decline, the increase is 44 percent). These calculations assume that current market rents are determined by projects financed at market rates of interest. If rents are determined in some markets by below-market tax-exempt financing, rent increases in those markets would be half again as large owing to the elimination of such financing. Thus the demand for housing by renters will be significantly reduced.

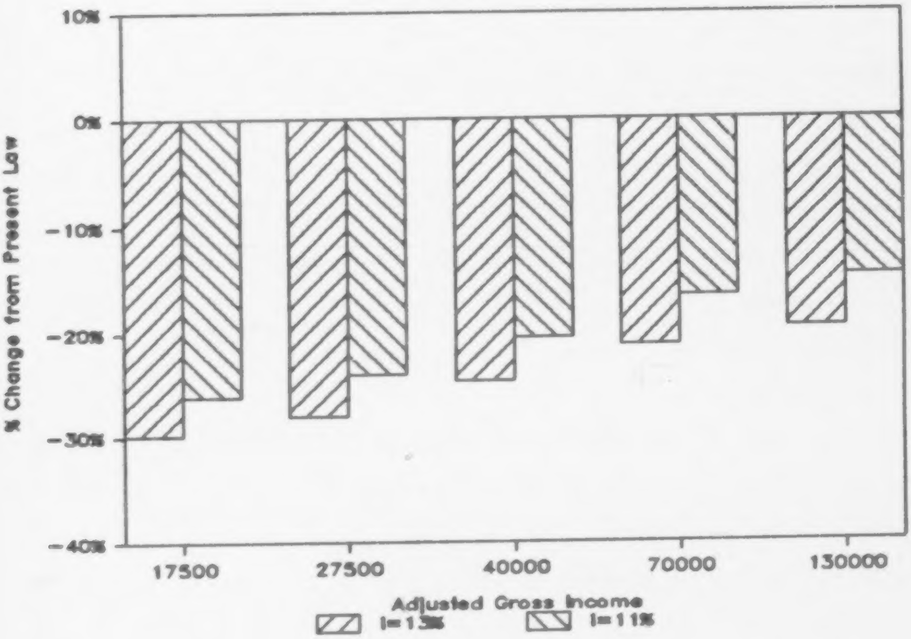
Recall, however, that the average tax rate of renters will be lowered, increasing their ability to pay higher rents. A renter with AGI of $70,000 who currently devotes less than 20 percent of income to rents could fund all of the rent increase with tax savings. A renter with AGI of $17,500 who currently devotes 25 percent of that income to rent could fund 30 percent of the increase in rent out of tax savings (1½ of 5 percentage points). Lower income renters who spend larger fractions of their income on rent would get negligible benefit from tax savings.

Figure 2 indicates the percentage change in the ratio of the prices of owner-occupied and rental housing. Owning will become substantially cheaper relative to renting whether or not rates decline. At the income levels of most renting households (under $25,000), owning will become 20 percent less expensive relative to renting. Thus we might expect a significant shift toward homeownership, and some renters who would appear to lose owing to the rise in rents will actually gain by switching their tenure mode.

Before concluding the analysis, it is useful to consider the interest indexation provision in isolation. Interest indexation would have a large negative direct effect on highly leveraged investments like rental housing because only part of interest would be deductible. Indexation would have no direct effect on owner-occupied housing under the Treasury's plan because home mortgage interest is excluded from indexation. On the other hand, indexation would have a large positive indirect effect on both rental and owner housing through the reduction in interest rates that it would induce (five-sixths of

10a

Impact of Treasury Proposal on Ratio of Costs of Owning to Renting



the 3.5 percentage point decline in the "maximum affordable" interest rate calculated in Appendix B is due to indexation). The sum of the direct and indirect effects on rental housing is about a wash, but indexation is unambigously favorable for owner-occupied housing. Put another way, removal of the indexation provision from the Treasury plan would likely not alter the above-calculated negative effect on rental housing, but it would change the generally positive effect on owner-occupied housing to a uniformly negative one.

IV. Summary

Current tax law provides tax advantages to owner-occupied housing that increase with a household's income level. This well understood fact has led to periodic proposals to substitute a tax credit equal to, say, 25 percent of housing-related expenses for their current deductibility. Because the proposed Treasury tax reform would remove the deductibility of property taxes and would create a flatter rate schedule, it would sharply reduce the tax-advantages of owner-occupied housing to higher income households relative to lower income households. If interest rates were unchanged, this change would be achieved by raising the cost of obtaining housing services from owner-occupied housing for higher-income households by even more than the increase for lower-income households, and thus would result in a decline in housing demand. With the anticipated two percentage point decline in interest rates, however, the relative reduction in the tax-advantage of higher income owner households would be largely accomplished by lowering the cost for low, middle and even upper middle income households and thus stimulating the demand for owner-occupied housing.

The cost of renting housing should rise sharply, 19 percent if a two point interest rate decline occurs. The resultant decline in rental housing demand per renting household would be cushioned by the roughly 15 percent average tax cut received by renters under the Treasury plan. A sharp decline (15 to 25 percent) in the ratio of the costs of obtaining housing services from owner and rental housing, regardless of the movement in interest rates, seems certain to raise homeownership significantly.

Appendix A: Methodology for Computing Prices of Obtaining Housing Services

To a first approximation, the annual cost of obtaining the use of the marginal dollar's worth of owner-occupied housing to the jth household (co_j) under current law is

$$co_j = (1-\tau_j)i - \pi + \gamma_s d + m + (1-\tau_j)p \qquad (A1)$$

where i is the mortgage rate, π is the expected rate of appreciation in the house, d is the depreciation rate (which is applied to only the structure portion, γ_s, of the house), m is the maintenance rate, p is the property tax rate, and τ_j is the marginal tax rate of the jth household. To compute the annual cost of obtaining the average dollar's worth of owner-occupied housing that households compare with the cost of obtaining rental housing in making their tenure choice, the τ_j must be redefined as the average rate at which interest is deducted. This annual cost should be reinterpreted as the cost of obtaining local services as well as housing services.

The approximate annual cost of renting a dollar's worth of housing (cr) can be obtained from an expression analogous to equation (A1):

$$(1-\tau)cr = (1-\beta\tau)i - (1-\tau_g)\pi + \gamma_s d + (1-\tau)p + (1-\tau)m - \tau\gamma_s d^*, \qquad (A2)$$

where τ is now the tax rate of the marginal investor in rental housing, β is the proportion of interest that is deductible (β=1 under current law), τ_g is the concurrent-equivalent tax rate on nominal capital gains, and d^* is the annual-equivalent rate at which the rental structure can be depreciated for tax purposes [d^* is the product of the present value of depreciation deductions and

$(1-\beta\tau)i - \pi + d]$. Equation (A2) differs from (A1) is a number of important ways. On one hand, the returns to investors in rental housing -- both rents (cr) and inflationary gains (π) -- are taxed (the latter lightly owing to deferral and a low statuary rate). On the other hand, maintenance expenditures and some depreciation measure are deductible.

The Treasury proposal would alter τ, β, τ_g and d^*. The tax rate is lowered from 0.50 to 0.35, β declines from unity to $0.06/(0.06+\pi)$ because only the proportion of interest that is real is deductible and the real rate will be assumed by the IRS to be 0.06, τ_g becomes zero because nominal capital gains are not taxed, and d^* is lowered at inflation rates below about 13percent and substantially lowered at 6 percent inflation (the depreciation rate is lowered to a straight 3 percent per year but it will be applied to an indexed basis). The Treasury calculations, Volume 2, Table 10, p. 172, suggest that d^* would be increased at inflation rates above about 10 percent. Their calculations are based on a real after-tax discount rate of 4 percent versus our 6 percent.

Our actual calculations are far more complicated than equations (A1) and (A2). Assumptions are needed regarding debt versus equity financing, the equity financing rate, the holding period and selling costs of the assets, recapture provisions and CPIT for rental housing, and the values of all the variables in the equations. These complications and our assumptions are discussed in "Tax Reform and Housing," NBER Working Paper No. 1524, November 1984; the most important parameter values are $i = 0.13$, $\pi = 0.06$ and $p = 0.012$.

Appendix B: The Decline in Interest Rates

We begin by simplifying equation (A2) in the following ways

(i) the first two terms on the right hand side are denoted by r, the real after-tax cost of funds facing a corporation,

(ii) the fourth and fifth terms are netted from the left-hand side, and $cr - p - m$ is denoted by ρ and labeled the marginal product of capital,

(iii) γ_s is set equal to unity and d^* is replaced by $z(r+d)$, where z is the present value of tax depreciation allowances obtained by discounting by $r + \pi$.

The result is

$$(1-\tau)\rho = (r+d)(1-\tau z). \tag{B1}$$

Next, we define the real after-tax rate relevant to corporate structures as

$$r = b(1-\beta\tau)i + (1-b)(1-\gamma\tau)e - \pi, \tag{B2}$$

where b is the portion of the investment that is debt financed, β and γ, respectively, are the portions of interest and dividends that are deductible at the corporate level, and e is the nominal required return to shareholders. Currently $\beta = 1$ and $\gamma = 0$. Portfolio equilibrium of investors requires that

$$(1-\tau_e)e = (1-\tau_i\beta)i + \delta, \tag{B3}$$

where τ_e and τ_i are the rates at which equity and bond returns are taxed at the personal level and δ is the risk premium required on equity. Substituting (B3) into (B2),

$$r = b(1-\beta\tau)i + (1-b)(1-\gamma\tau)\frac{(1-\tau_i\beta)i + \delta}{1 - \tau_e} - \pi \qquad (B2')$$

which simplifies to

$$r = b(1-\tau)i + (1-b)\frac{(1-\tau_i)i + \delta}{1 - \tau_e} - \pi$$

under current law ($\beta=1$; $\gamma=0$). With $\tau = \tau_i = 0.49$, $\tau_e = 0.2$, $i = 0.13$, $b = 0.4$, $\delta = 0.03$ and $\pi = 0.06$, r is currently 0.0387. With this r, z = 0.54, and with this r and z and d = 0.03, ρ is 0.0991.

We now ask how far the level of interest rates (i) must decline under the Treasury proposal in order for corporations to be willing to continue to invest in projects earning the before tax return (ρ) of 0.0991. With tax depreciation set equal to true economic depreciation at replacement cost and τ lowered to 0.33, we solve for the new r and z values (0.0466 and 0.41, respectively), holding ρ fixed at 0.0991. We then solve (B2') for i, given r = 0.0466 and the other parameters. Under the Treasury plan, $\beta = 0.06/(0.06+\pi)$ or 0.5 when $\pi = 0.06$. Also, one-half of dividends would be deductible. If half of earnings are paid out as dividends and half retained, $\gamma = 0.25$. Finally, τ_i would equal 0.35, and we estimate that τ_e would equal 0.17. With these and our other assumptions, the maximum affordable i becomes 0.0984. With reduced debt financing (b declining to 0.3) in response to its reduced deductibility and the partial dividend exclusion, the new level of rates would be 0.0939. Finally, with no indexation ($\beta = 1.0$ and b maintained at 0.4), the decline in rates is only a sixth as large -- the new level is 0.1241.

We have performed similar calculations for corporate equipment, which necessitates introducing the investment tax credit, k, into equation (B1) -- r+d is multiplied by 1-k-τz, not 1-τz -- and then setting k equal to zero under the Treasury plan. The maximum affordable i declines to 0.0705 (b=0.4) or 0.0661 (b=0.3).

Chairman **LaFalce**. I'll now go to the question period.

I personally come to the issue of tax reform with mixed emotions. I am inalterably opposed—as I said once before—to the elimination of the deductibility of State and local taxes. Unless that were eliminated from the overall Treasury plan, that would cause some real dilemmas for me. Let's hope we can resolve some of the dilemmas.

Hopefully, it would be good in the aggregate, but I am concerned at the economic dislocation that might take place that we're really unaware of, and won't be aware of, until we enact it. I don't know if we should overhaul 70 years of tax policy—which is really 70 years of housing policy—in one fell swoop, without putting in place simultaneously direct expenditures as opposed to tax expenditures, in order to effectuate the socioeconomic purposes we have deemed wise over the years, and implemented primarily through the Tax Code.

So, for example, we have said that construction in real estate should be favored. We have favored it primarily with an industrial policy through the Tax Code. We have had certain direct subsidies as opposed to tax subsidies, but for the most part they have been eliminated, as was pointed out in the testimony of the Home Builders.

In 1980, housing used to be from 5 to 6 percent of the Federal budget. Now it's less than 1 percent of the Federal budget.

And so my first point is, while I see the overall wisdom of trying to achieve as much neutrality as we can within the Tax Code, I'm wondering if we can do this or should do it without having in place simultaneously something on the direct spending side of the ledger to ameliorate the economic dislocations that I'm fearful of. That's the first question.

The second question, Mr. Hendershott, your praise for the Treasury plan, primarily, is based on the premise that interest rates would decline by about 2 percent overall. I'd like to think it's true; if it's true, it will make things a lot easier in forming a judgment. However, that premise seems to be based on an averaging out of the tendencies of the foreign investors and their interest sensitivity. If they're interest sensitive, interest rates might decline by about half a percent or 1 percent. If they're not, they might increase by about 3 percent or so. So, on average, they're going to decline about 2 percent.

You said: ". . . foreign saving is extremely interest-sensitive. Only a half percentage point decline might be expected. If foreign saving were insensitive, a 3½-percentage-point decline is a reasonable estimate." The 2-percentage-point decline is, of course, an average of these two extremes. But how do we arrive at an average. I mean, what justifies us in arriving at an average? Suppose they are extremely interest-sensitive as opposed to being insensitive. Then we might all experience your perspective of a half-percentage-point decline. Would you care to comment?

How sound is it to deal in averages on an issue of that import?

Mr. **Hendershott**. First of all, I'd like to ask you a question.

Chairman **LaFalce**. Not allowed. [Laughter.]

Mr. **Hendershott**. I did not understand your reference to my praise and embracing of the Treasury plan. While I don't want to take this truth and honesty too far, I did not mean to praise or embrace anything.

I was simply trying to lay out how I thought these three proposals would come down on real estate. I didn't mean to embrace any of them.

Regarding the decline in interest rates, I do not claim to be a professor of international finance, and if we did have a perfect international capital market, declines in interests rates in the United States would, of course, cause an outflow of foreign funds. The decline, therefore, would be only as large as the decline in the world level of interest rates, which might be a full percentage point given that the American capital stock represents about a third of the world capital stock.

I don't think we have any evidence that international capital flows are anywhere near perfect. On the other hand, we realize that we no longer exist in a world where there are not international capital flows. So I think the 3½ points we might get in a closed economy is too large a decline. I would be very comfortable saying that it would be between 1½ and 2½.

To get back to your first question, part of the problem of this sort of analysis is that we don't know everything; we can't say with certainty what the impacts are going to be. But I would emphasize that 2-percentage points is not an outside highest possible decline. The decline could very well be larger rather than smaller.

Chairman **LaFalce**. Mr. Dreier.

Mr. **Dreier**. Thank you very much, Mr. Chairman. First I'd like a statement that I have to be inserted in the record.

Chairman **LaFalce**. Without objection, so ordered.

Mr. **Dreier**. I praise you for bringing together members of both the business community and the academic world on this panel. I am very pleased to say that my family have been members of the National Association of Home Builders for three decades. I am especially pleased to see the president here.

I'd like to begin by asking the entire panel, do you favor some kind of reform of the present tax system that now exists? I'd like to ask all three to respond to that.

Mr. **Koelemij**. I think that basically what you're asking is to deal with the fairness issue. And I think there are probably steps that could be taken to remove that element of unfairness that might be now in the Tax Code, but I think that could be done in more than one way without destroying the economic structure under which we now do business.

Mr. **Dreier**. Does that mean without major reform?

Mr. **Koelemij**. Without major reform; yes, sir.

Mr. **Dreier**. Mr. Carter.

Mr. **Carter**. I tend to agree with that. I think that the constant flow of new tax measures that we've had over recent years has tended to do nothing but confuse the average taxpayer, both business and private. There certainly are certain provisions that could be modified and improved, but I think that an overall overhaul of the Tax Code at this time is just not appropriate.

Mr. **Dreier**. Mr. Hendershott.

Mr. **Hendershott**. It is clear that different types of capital in our economy are taxed enormously differently on the returns of different types of capital. I think the best example might be the investment tax credit applying to equipment. The cost of capital, if you will, or the effective tax rate on equipment, is far less than it is on structures, and I think, as an example, that the investment tax credit definitely ought to go.

Mr. **Dreier**. Do you think it is important that we have overall tax reform?

Mr. **Hendershott**. Yes, I do. And I think we ought to try and tax capital a little more equally. I think one of the major problems with the current law is the investment tax credit. Regarding the real estate industry itself, I would be a little embarrassed if I had a list of 10 tax changes that are eliminating or taking away tax advantages that my personal industry had.

I think it does make sense that we should tax real estate a little more heavily. There is no question about that. I also think, regarding tax reform, that we should close the loopholes on the personal side, that we definitely should take away—in the real estate sector, take away this treatment of second homes. Under current tax law, the price of owner-occupied housing for high-income people is much lower than it is for lower-income people. This is very hard to rationalize on either equity or efficiency grounds. And on the personal side, we have a number of fringe benefits—for professors and others—that are not taxed now and surely ought to be taxed.

I think there is a sense that the tax law is unfair.

Mr. **Dreier**. How about self-sacrifice?

Mr. **Hendershott**. I think basic tax reform is needed to give better compliance with the Tax Code.

Mr. **Dreier**. I inferred, as did the chairman, that you are most sympathetic toward the Treasury proposal. I would like to ask the other two witnesses to say which of the three major proposals before us are most appealing to them.

Mr. **Koelemij**. None of the above. [Laughter.]

To really come back, because I gave you what I thought was maybe the proper answer to your question, but I did not go into the details. I want to basically lay before you one premise, and that is that Congress for the past couple of years has found it proper to do away with direct subsidies for housing, and they said that tax incentives were much better and more efficient because they were more closely related to the marketplace.

It didn't have the overhead of the bureaucracy to go with it, and it just fit better than under the mode of trying to cut the budget deficit.

So since 1980, all these programs have been cut, and the only remaining elements that we have to provide shelter is through the Tax Code, and I think it is much more efficient, less costly to the Government.

Mr. **Dreier**. Mr. Carter.

Mr. **Carter**. We would prefer—no one of those is actually desirable, but if we had to take a choice, I'd say Kemp-Kasten.

Mr. **Dreier**. In my State of California——

Chairman **LaFalce**. Could Mr. Hendershott give his opinion on that?

Mr. **Hendershott**. I again have been saddled with praising the Treasury plan, although I think you are correct. If we had to choose one of these three plans, I would favor the Treasury plan, both because I favor homeownership, which the Treasury plan would definitely encourage, and because I think our financial system desperately needs a decline in interest rates.

On the other hand, if you took away the indexation feature from the Treasury plan, then I would favor Bradley-Gephardt.

Mr. DREIER. In my home State of California, we have seen a very chilling effect on the second home market, because of uncertainty relative to the Tax Code. There are ways to circumvent that that have already been proposed. One could, of course, refinance their principal residence and then, of course, use the principal to purchase that second home. But do you all see any other ways other than that to circumvent this concern, because in California, we have seen a tremendous impact because of uncertainty, as it now exists.

Mr. KOELEMIJ. The whole tax proposal has created uncertainty in the marketplace. You are correct, it is not only in California, it is in Pennsylvania, it's in Colorado, it's in Florida, it's in Texas, anywhere you have the tourist-oriented second home markets that are important.

If your question is, how do we prevent people from going to their primary residence to borrow additional funds to pay for the second home, that is not included in any of the proposals.

Mr. DREIER. What I am wondering is, do you know of any other ways to circumvent that proposal, if it were to become law, other than refinancing?

Mr. KOELEMIJ. No.

Mr. DREIER. You don't know of any other alternatives?

Mr. KOELEMIJ. No, sir, I do not. That would be the only type of interest that would remain deductible under the proposal.

Mr. DREIER. May I just ask one more question.

Chairman LAFALCE. Yes.

Mr. DREIER. Thank you very much. There was an article in the "Wall Street Journal" in December of last year, and I would like to read a quote from that article and get a response from the panel on it. This is from the December 12, 1984 article entitled "House Hunters May Want to Delay Buying Until the Tax Picture is Clearer."

> The tax break on mortgage interest has subsidized house purchases, inflating the housing market, according to some analysts. They point to the recent expansion of cooperative apartments and condominiums in New York as an example of the distorting effect the tax break has had. It is replacing a reasonably efficient rental system with an awkward condominium arrangement, just because the tax structure encourages change.

This quote is from Phillip Kagan, an economist at Columbia University.

Do any of the panelists care to respond to that?

Mr. KOELEMIJ. I don't know if I know enough about the market in New York.

Mr. DREIER. I am not an expert on that either.

Mr. KOELEMIJ. The fact that there have been conversions—you see, unfortunately, the city of New York is one of those that suffers from rent control, and sometimes the only way to keep properties viable is to try to get out from under rent control—and one way is to create a cooperative type of ownership, by which they pool maintenance, and so on. It also offers some different types of tax deductions to the individual cooperative owners, but I think the major reason is to have the ability to keep the buildings viable and to get out from rent control.

Mr. DREIER. Thank you very much, Mr. Chairman.

Chairman LAFALCE. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

I would also like to congratulate you on holding these hearings. I think it is very important that all Members of Congress start focusing more on some of these issues. Regardless of the preference of the National Association of Home Builders and the Associated General Contractors of America, it seems as if the tax debate is something that is being debated, and there is no way to stifle that.

Like you, I regret the passage of several of the past tax bills, but there is no way to stifle the debate, and the reason for that is, I feel, a felt need on the part of the American people, the average Americans, come every April 15, when they find themselves, no matter how well educated, unable to fill out their own tax returns. It is a simple question. I'd just like to ask each of you gentlemen if you fill out your personal income forms without the aid of an accountant or lawyer.

Mr. Carter, shall we begin with you?

Mr. CARTER. Since I am a CPA, I do fill out my own. [Laughter.]

Mr. COOPER. That is a good advantage to have. I wish I had that myself, but it takes several hours longer now, in order to deal with the code and find out what the changes have been since I made my return last year. So it is an ever-increasing complicated activity.

Mr. Koelemij.

Mr. KOELEMIJ. That is a difficult one. To answer your question, personally, I have a CPA who helps me fill out my tax return. I need to say also that while there are a lot of people who maybe do need help to fill out their tax returns, there are millions who don't, because they don't have the income levels or they don't use deductions, and do not understand what is in this bill. And there is one thing that I understand, and that is, that this bill does not create simplicity. In fact, it adds many items of complication to the code in indexing and depreciation, with respect to the indexed bases, and it takes another 500 pages of explanation by the Treasury Department after you have passed the bill.

Mr. COOPER. I certainly agree with you, there is a need for greater understanding. Since last summer, I mailed out to every constituent in my district a copy of the Bradley-Gephardt plan, so that they could see for themselves and figure out their own tax situations and see whether they came out better or worse off.

As a result, I guess what pains me more than anything, though, is that both the Home Builders and the Contractors, very distinguished organizations, very solid American organizations, and perhaps I misheard you, or something, but it didn't seem that either organization, despite our tremendous staffs and research capacities, that either organization is putting together its own preferred plan. It seems to me that from your testimony, what I was gathering is a sort of "Let's hear it for the status quo" attitude. "We've had too much change in the past. Let's keep things the way they are."

While that might benefit your industry, it seems to me a better course of action might be to investigate an alternative that might be able to preserve the prosperity of the basic economic conditions and yet try to achieve some equity for the average American.

Correct me if I am wrong, but has either organization undertaken a comprehensive effort on its own to come up with an alternative to any of the three tax plans we have discussed?

First, Mr. Koelemij.

Mr. KOELEMIJ. Mr. Cooper, we have not drafted a bill. What we have done since August of last year is spent a great amount of time and effort to properly analyze the tax proposals, as we then knew them, the Kemp-Kasten and the Bradley-Gephardt and later on the Treasury proposal and to study what the impact is, not only on just our industry, but also—people forget that when I sit here as the president of NAHB, I just do not only speak for my members, I speak for the people we serve, and they are the homeowners, and they are not sitting at this table. We also have to look out for the benefit of the homeowner and explain to you and to give you the information, as we gather it, on what effect it will have, so that you can make a very informed judgment after that is done.

Mr. COOPER. The conclusion of your research is to turn thumbs down on each of the three current proposals. And, again, your organization, with its beautiful building and intelligent staff, is not working today on a proposal of its own to simplify and reform the tax system, and yet preserve some of the incentives that are important for your industry.

Mr. KOELEMIJ. OK, Mr. Cooper. I would say this, that we are working to do that. We have to keep in mind that you probably know the saying that "if it ain't broke, don't fix it."

We are the best-housed Nation in this world, and we have done all this since the 1930's with all the incentives that we gave to create homeownership. And, in the sixties, when we had disasters like Watts or Detroit, the Government developed some assistance for low-income families to get shelter.

That has been diminished. So what I'm trying to tell you is that there is really nothing wrong with the system. The remaining vestiges in the Tax Code that deal with housing incentives, we feel, should remain there. And the treatment given in the tax proposals are so economically destructive, if you read Professor Hendershott's statement of the assumptions and what they're based upon. I'd rather not make these assumptions. I'd rather not go to bed with those. I'd rather do what you're doing today.

Mr. COOPER. Let's take one other example. Is the National Association of Home Builders in favor today of complete deductibility not only of second homes, but of third homes, fourth homes, fifth homes, et cetera?

Are you on record as saying that? That the current system is so fine that we don't need to look into situations like that?

Mr. KOELEMIJ. I think that this is a judgment factor, that it's not up to us to promote, Mr. Cooper.

What we are saying is that there is nothing bad about the status quo because the system is working. And if there are some inequities in the marketplace, then the Congress can just correct those inequities. The Treasury Department can correct many of the so-called inequities without rewriting the whole Tax Code. And we're still shaking in our boots over what happened in 1982 and 1984.

But, my time has expired. Thank you, Mr. Chairman.

Chairman **LaFalce**. I'm going to take the prerogative of the chair to ask a followup question to what Mr. Cooper was pursuing. I think he was attempting to elicit from you some present tax benefit that your industry is experiencing that you might be willing to forgo, either for the purpose of overall reform or deficit reduction.

Let me not be as gentle as Mr. Cooper was. Let me posit to you the elimination of all the tax breaks that your industry presently receives. Let me posit to you the passage of the Treasury bill as it presently stands, with one exception. And I leave that exception up to you.

What would that exception be, Mr. Koelemij? Mr. Carter? What one provision in the Tax Code is presently of such great import that that's the one you say we can't eliminate?

Mr. **Koelemij**. Mr. LaFalce, I can tell you that I was asked this question——

Chairman **LaFalce**. I'm not talking about the other tax proposals that exist; I'm talking about within the Treasury plan.

Mr. **Koelemij**. I was asked this question a while ago by Secretary Baker when we talked about this. We told him then, and I have to tell you now, that it is very difficult to point out one item that we say we could give up.

Chairman **LaFalce**. I know it's difficult, that's why I'm asking it.

Mr. **Koelemij**. Tax Code provisions are interdependent and relate to the whole system under which we now do business. And to say that indexing of interest we have said to be the most damaging, and so is that the one you opt for, but then indexing on capital gains treatment or the depreciation method; because one is more beneficial——

Chairman **LaFalce**. What about the elimination of the deduction of state and local taxes, including property taxes?

Mr. **Koelemij**. That's a very damaging aspect to homeownership, but we are not trying to take sides, in a sense, for homeownership against rental properties or investor properties, because it would be unfair to do that.

But that's why we pointed out the effects of all of them as they are now included in the proposal.

Chairman **LaFalce**. How about you, Mr. Carter?

Mr. **Carter**. Basically, I think we're talking about several different sectors of the economy and the proposal hits on all of those things. As individual companies, construction companies, we would prefer to retain, say, the completed contract accounting and the exemptions under the present law. As the Treasury's proposals would impact on the entire construction industry, the accelerated cost of depreciation could be important.

If you're talking about private sector construction as opposed to public sector construction, maybe the industrial development bonds, tax-free bonds, could be important.

So I think it's not possible to pick one out of a whole laundry list and say that is the one that should be retained and all the rest have to go.

If I might, I'd like to add just a brief comment that was made by Mr. Doug Pittcock, immediate past president of AGC, in January of this year.

The U.S. economy has staged a truly remarkable recovery since the recession bottomed out in November 1982. In the 2 years that have passed, the gross national product has grown by more than 20 percent—12 percent after adjusting for inflation.

This amazing economic strength has added 6,797,000 workers to the payrolls in the last 2 years, dropping the unemployment rate from 10.7 percent to 7.2 percent. At the same time, inflation has moderated from a rate above 13 percent in 1980 to under 4 percent in 1984.

And, from all signs, the economy appears to be capable of continuing this strong performance well into 1985. Some observers may take notice that the construction industry embarked on two successive years of record volume beginning in late 1982. The annual rate of construction put in place in November 1984 was almost 42 percent.

Chairman **LaFalce**. This is very interesting, Mr. Carter. I don't think it addresses the question that I posed.

Mr. **Carter**. I believe it does, sir, if you'll just let me finish, one more brief comment. Since September of 1982, dropping the rate of unemployment in the industry from 20 percent to 13.7 percent, a low rate by historical standards for construction. Construction activity is still booming with construction occurring at a remarkable $322.2 billion annual rate as of November 1984, with industrial office and commercial building leading the way.

Now, the point I really want to make is that construction is tied to the economy and when we do things to the Tax Code that suppress or stifle or smother construction, then we have an impact on the overall economy.

The Department of Commerce released statistics showing that construction as a percentage of gross national product was a low of 7.5 percent in 1982, which was also the low point in the economy. It has now grown to 8.46 percent of the economy.

A recent study made by AGC through Data Resources, Inc. estimated that construction has a 2.35 gross national product multiplier impact on the economy.

So I think the point is it's not possible to stifle construction and have economic growth.

Chairman **LaFalce**. Thank you. We'll get back to that in a second. I'll now go on to Mr. Wortley for his questions. Thank you.

Mr. **Wortley**. Thank you, Mr. Chairman. I haven't jumped on the bandwagon yet for either the flat rate tax, the modified flat rate or the Treasury plan. It just appears to me, in spite of all the imperfections of the existing Tax Code, that it has, in reality, fostered one of the greatest economic recoveries that this country has ever had without the benefit of a lot of public works programs. But, obviously, there are perhaps——

Chairman **LaFalce**. Some have said we have had a public works program implemented through the Tax Code, especially office buildings, with the vacancy rate right now in office buildings.

Mr. **Wortley**. I'll tell you people are still investing, and, Mr. Chairman, that's what's important. That's the direction I think

America is heading. And I think it is positive, but there are some imperfections in the Tax Code, such as shelters that need to be closed off.

If tax reform were enacted on a step-by-step basis, tightening up a little bit, what incentives or preferences would each of you gentlemen think should be left untouched?

Why don't we start out with Mr. Koelemij?

Mr. **Koelemij**. Mr. Wortley, that's almost the same question I had before. We feel that the remaining incentives that are in the Tax Code at the present time are incentives, they are not loopholes. They were put there for a period of years to make this the best-housed Nation in the world.

Now I don't know if the Treasury Department or the administration or the Congress feels that we are too well housed in this country. We feel we're not. We still have problems with that.

We feel that the attempt of creating—I don't know what it is. It's not creating simplification, but to create fairness, there are maybe other ways to accomplish that than by restructuring the Tax Code as now proposed in the proposals that are before us.

And, in addition to that, we are looking at proposals. The Stark-Chafee proposal, which has a preference reduction, that maybe is an answer. But what I'm saying is that we really can't embrace any of the ones that deal with the provision of housing and shelter, and the encouragement of capital investment.

Mr. **Wortley**. I was looking for something kind of specific. The capital gains tax should not be changed. Maybe the deduction of interest on all homes, whether it's one home or four, five or six that Jim Cooper was referring to, is the deduction for property taxes.

What three or four things might there be that you feel that you just can't touch otherwise, or you destroy the whole program?

Mr. **Koelemij**. The difficulty, Mr. Wortley, is that to pick one of those that you would pick one segment of the housing industry. We feel that is unfair. Therefore, at this time, we have pointed out the effects that each one of these related proposals have. Then we have to do the best we can as we go along in trying to either advise and counsel with Members of the Congress and to come up with a bill.

Mr. **Wortley**. In other words, you wouldn't touch anything in the existing Tax Code that affected housing because you believe all of those are strong points to continue a viable expansion program?

Mr. **Koelemij**. That is correct, yes, sir.

Mr. **Wortley**. How about you, Mr. Carter?

Mr. **Carter**. Thank you, Mr. Wortley. We sort of feel the same way. We agree there are abuses of the Tax Code—abuse of shelters, manipulation of the code—and that creates inequities. But those inequities and abuses are not going to be corrected by any of the proposals that Treasury has made.

We think that if Treasury would enforce the laws and regulations they have in place at this time, that many of those abuses could be eliminated. The few areas that do need to be corrected could be addressed. The Treasury is spending all this time trying to write regulations for laws that were passed in 1982. And they still haven't issued regulations for them. We just think they need to get on with enforcing the law rather than changing it every year.

And these proposals, we believe, would have the direct opposite impact; that is, it's not fair, it's not simple, and it's certainly not promoting economic growth.

Mr. **Wortley**. Thank you.

Mr. Hendershott.

Mr. **Hendershott**. I feel considerable sympathy for the committee. It's almost as though you are asking the Secretary of Defense which part of the military budget we don't need.

Mr. **Wortley**. Have you got any answer to that? [Laughter.]

Mr. **Hendershott**. I do have a couple of points I would like to make. For one thing, I don't fully understand the positions some of the trade associations take on these bills. For example, I think that the Treasury plan is positive for single-family housing. Very positive. I do not think that the homebuilders are speaking for homeowners when they say that they don't want that plan passed.

Chairman **LaFalce**. Who do you think they're speaking for?

Mr. **Hendershott**. I think they're speaking for builders and I can only gather they are speaking for builders of rental properties as opposed to single-family houses. There's no question that the Treasury plan is going to have a negative impact on rental housing.

On the other hand——

Chairman **LaFalce**. Which is maybe why, if we are going to deal with rental housing, we ought to have something on the direct spending side.

Mr. **Hendershott**. In our analysis of the Treasury plan, we did look at what would happen to renters as well as owners. Under the Treasury plan, business taxes are supposed to go up 25 percent and people, or individual households, get an 8-percent cut. We think most of that cut is going to renters. So renters are going to benefit by a personal tax cut underneath the Treasury plan.

Also, some renters are going to benefit because they're going to become owners. The cost of owning is going to drop sharply relative to renting. But, at the low-income end of the rental, there's going to be significant problems. Poor people cannot afford to pay market rents any more than they can afford to pay market prices for food.

If the Treasury plan were passed, I think there would be, or should be, some concern regarding low-income renters.

Mr. **Wortley**. If the Treasury bill were passed, it certainly would have a chilling effect upon rental housing. We all agree on that.

Mr. **Hendershott**. No question.

Mr. **Wortley**. Who is going to provide the housing for people who can't afford to go out and own their own homes? Should we turn to the Government and ask the Government to get involved in more public housing?

Mr. **Hendershott**. There would obviously be some switching of people wanting to own. Empty rental units will be created as people shift to ownership.

But there's no doubt that there will be a cutback in rental construction for some time.

Mr. **Wortley**. We're going to have to get the Government more deeply involved in providing public housing.

Mr. **Hendershott**. There's no question that if you are going to assist low-income people, it's going to cost money. It would, however, be far preferable to assist people with vouchers for rental payments rather than to expand public housing.

Mr. WORTLEY. What about all those people that are in between, who can't afford, if the Treasury bill went through, who can't afford to go out and buy their own homes?

But, nevertheless, may I ask one more question?

Mr. Koelemij, tell me, in your observation, has the Treasury proposal had a chilling effect or created an uncertainty on immediate plans for construction of real estate projects?

Mr. KOELEMIJ. Yes, Mr. Wortley, it has. That was our first reaction to the proposal in November, to ask the Treasury and, later on, ask the administration to make a statement as to effective dates of this proposal, because we immediately noted a sharp downturn in activities in the second home market. And syndication which is the attraction of capital into investment property.

If you would permit me, because the question was raised, for whom I speak and who do we speak for—builders or homeowners—I need to tell you that the Treasury proposal is so-called revenue neutral. I can tell you, it's not because of what it does; in a sense, it shifts $168 billion in 3 years from individuals to corporations. And, you know, everybody knows and everybody says, that corporations do not pay taxes. But it will result in higher costs for goods and services to the consumers, who are also the homeowners.

And second is the assumption that Mr. Hendershott makes is based upon his own statement that there is substantial uncertainty about the reaction of the flow of capital. I can guarantee you that foreign capital is interest-sensitive. Mr. Volcker testified to that fact 2 months ago and said that he was fearful of the price that he would have to pay if the dollar value dropped. How much money would we have to pay to keep the foreign money in this country? And just to base the sole assumption that interest rates will drop anywhere from 0.5 point to 4 points and an average of two is absurd. I hate to disagree that strongly with Mr. Hendershott and I hope he will not give me an F, but it is nonsense. It just is not supported.

Mr. WORTLEY. I'll give you an A. Thank you very much for your testimony, gentlemen.

Chairman LAFALCE. While you are passing out A's and F's, you will have to give out F's to Rutgers University, the American Enterprise Institute, and, as I understand some of the premises of Mr. Hendershott, those other entities reaching the same conclusion that he has. So we ought not to just dismiss it.

Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

The point is that last year the Tax Code had $330 billion worth of tax expenditures annually. This year it is going to be even more, I guess. Maybe that was brought out. Almost $400 billion, I guess.

The question, I think, in terms of these tax expenditures that are discussed is that some of them are politically not feasible, and there are other problems, and some do a lot of good. The question is: How are they all more or less working?

There are a disproportionate number that go to homeownership, real estate. The reason for that is not a recent shift. There has always been a tendency to tilt in that direction because of our social goals.

I don't know if this is the best way to accomplish that or not, through the Tax Code. There are some inefficiencies, but you almost accept that going in.

The IRS just can't manage or limit those dollars in the same way they are otherwise limited, but most of us are going to accept that before and after the so-called tax simplification; we are still going to have that as a factor.

The question to Mr. Hendershott is: In other words, you claim it carries advantages to real estate? On the basis of that—and I tried to understand this, and I am surprised the Congressional Research Service and others take this particular view because we are in this committee, among other things, also students of monetary policy, and I want to tell you if there is anything that isn't certain, it is that.

If there is anyone that doesn't want to take credit for setting interest rates, it is the bureaucrats in Washington, including the Federal Reserve Board and probably most of us in Congress through the Tax Code or any other means. And so, when you make this dramatic prediction about the fact that there is going to be less demand for credit based on the fact that marginal rates will be substantially reduced, I really wonder if marginal rates would be reduced. That is the statement. I just wonder. I guess it all kind of revolves around whether marginal rate reductions for a whole host of credit consumers, both business, corporate, and individuals.

I just wonder about the whole premise there, Mr. Hendershott. Maybe you would like to comment about that briefly, and explain it.

Mr. HENDERSHOTT. I would be very happy to do so, but first I would like to respond to Mr. Koelemij's statement that expecting a significant decline in interest rates is nonsensical. Even the NAHB's own analysis dated March 1, 1985, concludes that interest rates could possibly fall by 100 to 150 basis points, with 200 basis points as the maximum reasonable estimate of decline under the Treasury proposal—page 30. How quickly "reasonable" has become "nonsensical."

Interest rates depend on what people undertaking real investments can afford to pay, given what the real investments are expected to earn. Right now the returns on real investments are sufficient for borrowers to pay a market mortgage rate of 13 percent or corporate a bond rate of 12 percent.

What would happen if you took away the investment tax credit. Would corporations still be able to pay 12 percent to invest in equipment if they didn't have the investment tax credit or if you took away the very short tax lives and made corporations depreciate the equipment over a longer period of time?

Mr. VENTO. Aren't there a number of factors here, not the least of which is interest rates, but what you are willing to pay for the cost, for the timing?

In other words, are you predicting that there will be a substantial reduction in the cost of these various products because of the lower marginal rate, as an example? That it is all going to be taken out of interest rates is what you are suggesting; the entire saving would be attributed to it.

I don't know if I disagree or agree with you, Mr. Hendershott. I am just trying to understand how we are getting to this particular point, I guess, that is felt by others, too, in the same way, Mr. Hendershott.

Mr. **Hendershott**. If you take away the investment tax credit and you say that equipment has to be depreciated over 8 years instead of 3 years, the investments are no longer profitable unless interest rates decline.

Look at Bradley-Gephardt, which takes away tax breaks for every kind of real capital you can imagine in the economy. At current interest rates, there would be a substantial decline in the demand for funds to finance investments because it wouldn't make sense to make the investments otherwise. Interest rates would have to decline in order to get a new equilibrium so those investments would go forward.

And I am sure that the Federal Reserve would be very willing to accelerate that decline in interest rates because they don't want a slowdown in the economy any more than anyone else.

Mr. **Vento**. I understand the basic premise, I think, of what you are suggesting, but what about the basic price of the commodities themselves, of the house or real estate? What about the international markets?

Are there any markets, incidentally, where they have lower marginal rates where you can actually demonstrate that?

Mr. **Hendershott**. You keep referring to lower marginal rates, but I don't even mention lower marginal rates in my discussion of the decline in interest rates.

In my example to illustrate the rate decline that would result from the Treasury plan, I didn't lower the marginal rates. I said let's assume the marginal investors are in the 50-percent tax bracket and require after-tax returns of 6 percent? The level of pretax interest rates would have to be 12 percent. But if you introduce indexation, the level of rates can fall to 8 percent, and they will still get the 6 percent after tax because the Government is going to take a much smaller part of the interest.

Mr. **Vento**. I guess the thing that I am suggesting is that it is such an important point. I know that there is no perfect model, whether we could compare it with anyplace else where they have this type of a change. We are talking about, I guess, more a pure economic response.

But even with the pure economic response—and getting back apparently to what you want to talk about and not addressing the other things, which apparently you don't want to talk about—but getting back to that, you said 12 percent versus 8 percent with the indexation of interest rates.

What about the home mortgage for the individual homeowner? They don't have an indexed mortgage rate in that particular scenario. In the absence of mortgage interest deductions, and so forth, that they do have, wouldn't they be disadvantaged, at least in that particular example?

Mr. **Hendershott**. No. All interest rates are going to move together. Mortgage borrowers are, in fact, going to be advantaged in that example, because rates fall to 8 percent and they are able to deduct the full amount.

Mr. **Vento**. How are they going to be advantaged if home mortgage interest rates are not indexed? And disregarding the mortgage interest rate deduction, leaving that aside for a moment, I am trying to get you to agree with me so I know I am understanding you, yet you seem to be going in the opposite direction.

Chairman **LaFalce**. Maybe you ought to ask new questions.

Mr. **Vento**. I guess so.

Mr. Koelemij, do you follow what I am just saying with regard to this question? If not, I would like you to respond to it.

Mr. **Koelemij**. Mr. Vento, your colloquy with Mr. Hendershott shows how uncomfortable I feel by the burden on Members of the Congress to make these kinds of changes based upon these uncertainties that Mr. Hendershott is bringing to you, to assume that something—what I understand is this:

When I submit to my banker a performance statement on my new apartment project, I can show him I have *x* numbers of dollars of income, I can deduct certain expenses, and all the expenses I will not know——

Mr. **Vento**. Mr. Koelemij, my time is very limited. Do you think that homeowners are going to look at marginal rates of what they will be paying?

Obviously, there is a factor here. We know if we buy a home you get to deduct the interest and do other things, and we have lower rates.

Do you think that will translate? Do you think they will be looking at that, and do you think that is what they will be looking at and the bankers will be looking at—that marginal rate—when they make these credit judgments?

Mr. **Koelemij**. I don't believe that, Mr. Vento.

Mr. **Vento**. I find in my experience that is the case because even today we are having a hard time getting to look at adjustable rate mortgage changes. In other words, all we are looking at is the way that people come in. They don't sometimes look beyond that, which has been somewhat of a problem.

Mr. **Koelemij**. The purchase of a home is not only just a business judgment on the part of people. It is also an emotional judgment, and that comes with it, too. But I think the anticipation of what the Federal Reserve Board might do—and I wonder why they haven't done it before when we had 20 percent rates and 17 percent rates and people couldn't buy a home—I think that the pressures on the capital markets are going to be exactly the same.

But if the financial institutions are going to pay less taxes, then at least they can recoup some by greater profits because they need it. The savings and loans are broke. They have minus assets, and the FSLIC is in danger. They are looking for a greater return on their investments so they can remain viable because we need it in this industry.

Mr. **Vento**. Mr. Chairman, thank you. This is a very good topic. I think it is the sort of question we should be asking ourselves before we plunge head first into simplification, and I commend you for your efforts.

And, Mr. Hendershott, although maybe I didn't reflect it, I thank you for your participation.

Chairman LAFALCE. Thank you.

Mr. Carper?

Mr. CARPER. Thank you, Mr. Chairman. Welcome, gentlemen. I see you spend some time in Ohio State, Mr. Hendershott. As someone who spent about 4 years there, as a graduate, I particularly welcome you to this hearing today.

I have been in another subcommittee hearing earlier this morning. I regret not having been here with you having presented your testimony.

Let me just ask, starting with you, Dr. Hendershott, if you will—it seems there are some areas where you clearly disagree with the other witnesses—might you just tell us where you saw some common ground amongst yourselves?

Mr. HENDERSHOTT. I think there is clearly common ground on what the impact on rental housing will be. There is no question that rents in the rental sector are going to have to rise if the Treasury plan were passed.

There is a disagreement as to how much they are going to have to rise. The disagreement again stems because of the difference in interest rate assumptions. I argue that residential rents would have to rise by 20 percent, and I think the other people were talking more like 40 or 50.

Mr. CARPER. Can you think of some other areas where you might have agreed?

Mr. HENDERSHOTT. Probably not. I am not sure there are at this point.

Mr. CARPER. Mr. Carter, how about you? Where did you find yourself in agreement with the other panel members?

Mr. CARTER. I think the Associated General Contractors, which are primarily building facilities for another owner—we don't own them. We are not generally developers. We don't build it for rent, that kind of thing. But basically, I think we agree with Mr. Koelemij in many of the areas he is talking about, not perhaps for the same reasons but because we see—while Mr. Koelemij's position will have an impact on the homebuilder or the homeowner or the rental property builder, we see it as having an impact on the people who are willing to build new facilities, even governments, who are willing to build and pay the prices for new highways, new bridges, new powerplants, those types of facilities.

So I think we just basically agree with Mr. Koelemij and disagree with Professor Hendershott.

Mr. CARPER. You don't agree with Dr. Hendershott on anything that he said?

Mr. CARTER. We agree that the Treasury proposal would have the impact on homeowners and on rental property. And the chairman earlier commented that if these were going to be proposed or were going to be adopted, it would appear that we need to have some direct spending proposals to go along with it.

But by definition, Treasury's proposal is supposed to be revenue neutral. So if we implement the Treasury proposal and then add on top of that additional direct government spending, we have not improved the Tax Code, nor have we improved the deficit.

Mr. CARPER. Thank you.

Mr. Koelemij, same question to you, particularly with regard to Dr. Hendershott's testimony: could you find some common ground?

Mr. KOELEMIJ. I would say this: We disagree with Dr. Hendershott only, I think, on the interest rate assumptions that he makes. In that element, we agree with him that they create substantial uncertainty. Mr. Carter has just said that we basically agree.

And I think what is pointed out from our viewpoint is that the way we look at this it would appear that debate on tax reform and simplification is really going to be a debate on national policy on housing.

Are we going to have a national policy on housing, and are we going to remove the last efforts that the government has made since the 1930's to provide homeownership and affordable rental housing? Is that going to be changed?

We feel that the tax proposals are causing great changes, if they were enacted in the form they are now being proposed.

Mr. CARPER. Given the problems of home building and home ownership in our country, do you think it is realistic for us to expect a major reform of the Tax Code that does not at least touch directly or indirectly on interests that are vital to your industry?

Mr. KOELEMIJ. Of course, they do affect the industry and the homeowners as well as the renters of this country. That is why we have analyzed the proposals so deeply, to point this out to whoever might like to look at it. We hope that we have submitted it in our statement and that the committee will take advantage of it, and we stand ready to give any further explanation that you might want.

Mr. CARPER. Earlier in the questioning, the chairman of the subcommittee, I believe, asked you to pick out one element within the Treasury tax plan that you would change if you had to scuttle all the others. I know that is a difficult question to ask of you. I suspect it is a variation on the question we have asked repeatedly as we actually address the issue.

If we actually address the issue of tax reform, we are going to be asking you to set some sort of priorities in terms of not what is your worst evil to swallow but what would be some of the lesser evils. I am sure you know that is coming.

I would simply say to the extent that you could bear with us, and especially the Ways and Means Committee, that would be helpful.

One last question, Mr. Chairman, and that is to address the portions of the Treasury tax proposal that deal with incentives for savings. We don't seem to do real well as a Nation in saving our money. We like to spend it, and we have some incentives that give us a tax break—interest on our credit card—but what kind of thoughts do you have along the line of drafting a tax bill that would change somewhat the incentives and disincentives for saving?

Mr. KOELEMIJ. Mr. Carper, you are probably referring to the fact that often statements are made that people in Japan or Germany save more of their income than we do in this country, but we overlook an important factor; that is, that in this country, two-thirds of the people own a home, and the value of that homeownership is something like $2.27 trillion.

In my State we have many elderly people who are using the equity in their homes, with a reverse annuity mortgage, to supplement their income or their retirement at the present time.

If we overlook that as savings, I think we make a mistake. That is an expression of equity. That, to me, is worth more than a bank account.

Mr. CARPER. So you would give us no counsel in terms of changing incentives for savings?

Mr. KOELEMIJ. It's always good for us to have more savings. I think that is why the IRA account and the proposed increase in the IRA account is good. I think, the more we can do to make people more independent of government, to provide for their waning days, is a good effort, and we should support it because you see what a struggle we have with the COLA's in Social Security, and you have to face that every year.

The more we remove that pressure, the better off we are.

And I think IRA is one of the good elements that you have created through acts of Congress to create savings in this country.

Mr. CARPER. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you, Mr. Carper.

It's not often that I find myself in agreement with President Reagan, but when listening to his radio address on the Treasury tax plan, he did make one statement with which I found myself in considerable agreement. And I ask you gentlemen if you agree or disagree with the President and myself. He said:

> Have you ever heard of a see-through building? It's one that has no interior walls because it has no tenants. Between 1983 and 1984, only about half of the increase in available commercial office space was reflected in rentals. The other half resulted in vacancies. The tax benefits for investment in some kinds of real estate deals are so generous that being able to rent space may be secondary. The result is overbuilding and high-vacancy rates in many American cities.

Is the President right or wrong? Mr. Koelemij?

Mr. KOELEMIJ. If you put it that way, the President is right.

Chairman LAFALCE. Thank you. Mr. Carter?

Mr. CARTER. As you say, if the President is speaking of a specific area, he's correct.

Chairman LAFALCE. Mr. Hendershott?

Mr. HENDERSHOTT. This reminds me of an earlier statement made by Congressman Dreier, I think, to the effect that any investing in second homes that are idle 11 months of the year, or investing in office buildings that are empty is not good enough. Some investment is a costly waste of resources.

Chairman LAFALCE. All right, now let's come back. I'm going to give you another chance. Mr. Koelemij, I wasn't going to cut you off that abruptly without giving you a second chance. But I wanted to just get it across the board.

There is some validity then in what the President was saying.

Now, initially, I had asked you to pick one provision in the tax bill that you wanted to retain and we're going to pass all the others. I couldn't pin you down. I'm trying to do what Mr. Cooper attempted to do in the other direction, because I assume that you gentlemen come to this table considering it a bargaining table where you don't offer anything initially and you say the status quo is perfect.

But I also suspect that if you are confronted with reality, either overall tax reform or the necessity of raising some portion of your revenues through the Tax Code, in order to help reduce the deficit, that you'd then be willing to deal.

It's going to be difficult for me to assume we're at that point because we're not. But I'm assuming that we are going to work our way to the point where we are going to have to reduce the deficit, in part, through enhanced revenues. I don't mean increasing the tax rates on individuals. I don't mean increasing the tax rates on corporations. But I mean trimming some of these expenditures.

If we have had a public works job program over the past 4 years and it has been office buildings, what type of tax expenditures could we trim to enhance revenues and eliminate or reduce the overbuilding in office buildings?

What about some of these tax syndication proposals for office buildings? Mr. Hendershott? Mr. Koelemij? Mr. Carter?

Mr. KOELEMIJ. Well, when you come to the office buildings, Mr. Chairman, there are problems in Houston, TX. That's a very isolated situation. That is where the biggest overbuilding of office buildings has taken place.

Chairman LAFALCE. It's happening across the United States.

Mr. KOELEMIJ. Not according to my information.

Chairman LAFALCE. According to a study recently released by MIT, and my understanding was that this was a nationwide study, the U.S. office vacancy rate in 1980 was less than 6 percent, and, today, it is approximately 16 percent.

Mr. KOELEMIJ. What I'm trying to tell you, I don't know the exact impact of the Houston market on that 16 percent, but I can tell you this, that to construct an office building, the planning alone takes 2 years or more. And when the glut came into the oil business and to the expansion of oil activities, Houston slowed down.

I need to also point out to you that many of these syndications or the ownership of these buildings are in the hands of foreigners. They do not pay taxes in the United States and they do not get tax benefits in the United States. So it doesn't cost us tax income from the particular ownership that is by foreigners.

Chairman LAFALCE. I wonder what percentage that is.

Mr. KOELEMIJ. I don't know. I'm going to try to look it up.

Chairman LAFALCE. They didn't have a high rental rate. I wonder why they would invest in them.

Mr. KOELEMIJ. Because they have a lot of confidence in the real estate market in this country.

Chairman LAFALCE. Well, they're not fools.

Mr. KOELEMIJ. But they do make a lot of commitments. Foreign investment funds or pension funds, that money is coming into this country very heavily.

Chairman LAFALCE. But they'll want a return on their investment though, and I can't see how they get that if the tax bill doesn't work to their benefit.

Mr. CARTER. Mr. Chairman, office construction is typically cyclical. As Mr. Koelemij says, it takes a long time to plan and a long time to put it on line. No investor, regardless of how much money he has, is going to invest in a building that he knows is going to stand empty—even in Houston. I agree that Houston probably is the most spotlighted place in the country with overbuilding, but they are going to catch up when the oil industry catches up.

Chairman LAFALCE. Mr. Koelemij, what percentage of the homebuilding that goes on in the United States involving the membership of the National Association of Home Builders, involves depreciable property?

By "depreciable property," I mean for tax purposes.

Mr. KOELEMIJ. Well, if you look at the rental markets, so to speak.

Chairman LAFALCE. The rental market is obviously depreciable.

Mr. KOELEMIJ. For the rest, it's rather small.

Chairman LAFALCE. So your membership would not be that adversely affected, would it, by a change in ACRS?

Mr. KOELEMIJ. There would be. But what I was going to tell you was that many of us have built as part of our subdivision development, or planned unit development, little shopping centers, little regional doctor's offices and a drugstore, and that is strictly our retirement fund, so to speak. That has happened.

Chairman LAFALCE. This goes to Mr. Hendershott's question as to who you're speaking for. Now you're speaking for your retirement funds, or are you speaking for single homeownership?

Would a change in ACRS adversely affect single-home ownership or the building of new single homes in the United States? Does this question, Mr. Hendershott, get at the thrust of what your remark was?

Mr. HENDERSHOTT. Yes; it's clear that reducing the attractiveness of rental housing has got to be good for homeownership. And it would have to be good for builders of single-family houses.

Chairman LAFALCE. Mr. Koelemij?

Mr. KOELEMIJ. You know, Mr. Chairman, I speak for the industry. I don't single out single-family builders, multifamily builders, or people who happen to have built some depreciable rental property for their own investment.

If we couldn't do that, Mr. Chairman, we couldn't overcome the period of 1979 to 1982. We would have been busted. I wouldn't be here if I was not the owner of some rental property that kept me through the bad days when interest rates were 20 percent.

So if we don't do that, we won't remain a viable industry to build homes tomorrow.

Chairman LAFALCE. The hearing is going to have to come to a close. Let me just make this one observation.

With so-called tax reform, or tax change, it's unclear whether it's good or bad. I don't see how we would be able to enact it into law with the total elimination or reduction of tax expenditures that are called for in any of the major plans.

Ergo, if it is to be revenue neutral, and I don't think it should be revenue neutral—I think it should be revenue enhancing—but if it is to be revenue neutral, we would not be able to give all the individual and corporate tax cuts that are envisioned by all the plans. I think we would have a coincidence of interest here, and I would urge you to argue for it.

If something has to go, I would rather see a reduction in the progressivity of the rates go, as opposed to the increase in the personal exemption in the zero bracket amount.

I think you would achieve much greater equity if we could keep the progressivity of the Tax Code and increase the personal exemption and standard deduction in the zero bracket amount. I would think this would be in the interests of the Home Builders and AGC, too, because the more progressive your Tax Code is, the higher your tax expenditure is for your purposes.

I'm just saying, if you have to choose between the two, what I would opt to have changed is increasing the personal exemption as opposed to reducing the rates. I think there's a coexistence of interest between my perspective and the perspective of your association.

Any comments on that?

Mr. CARTER. I would tend to agree with that, sir. The personal interest rates, the personal tax rates—of course, a lot of people would say they're too high.

Chairman LAFALCE. The personal exemption and standard deduction are too low.

Mr. CARTER. That's right. I think there is still some argument for keeping those where they are now, at least until something is done to the deficit.

Mr. KOELEMIJ. The only problem, Mr. Chairman, is that when we discussed some of these alternatives with the Treasury Department, they told us that the increase of the personal deduction by $100 costs $5 billion to the Treasury.

Chairman LAFALCE. I understand.

Mr. KOELEMIJ. Then you start to look again at the impact on the budget.

Chairman LAFALCE. My point is, assuming that we are going to enact the Treasury Department plan, but only in part—let's say we would enact 50 percent on the elimination of the tax expenditure side. That would mean we couldn't both reduce rates and increase the personal exemption and standard deduction. I am suggesting to you that it would be in your interest, if it works out that way, to argue that what the Treasury Department should forgo is a reduction of the rates as opposed to an increase in the personal exemption and standard deduction.

I think there is a mutuality of interest between the individual taxpayers of this country and your association in seeing to it that we increase the personal exemption and standard deduction as opposed to the rates.

Mr. KOELEMIJ. We would agree with you on that.

Chairman LAFALCE. Mr. Hendershott, any comments on your part?

Mr. HENDERSHOTT. No.

Chairman LAFALCE. Gentlemen, thank you very much for another interesting, educational, and informative hearing. We look forward to working with you in the future on this issue—I shouldn't say progresses, but as it's further discussed.

Thank you very much.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[The following additional material was submitted for inclusion in the record:]

STATEMENT OF THE HONORABLE DAVID DREIER
SUBCOMMITTEE ON ECONOMIC STABILIZATION
TUESDAY, APRIL 23, 1985

Mr. Chairman, I congratulate you on calling these hearings. Tax reform is, next to reducing the deficit, one of the key issues facing the 99th Congress. It's an issue that is long overdue, and one that I hope will be resolved fairly, completely, and above all, promptly by this Congress -- not the 100th Congress.

It's no surprise that the road to tax simplification is a long one. It necessitates trade-offs, sacrifices and compromises. But the bottom line is that we all have something to gain from tax reform -- lower tax rates for all taxpayers and a stronger, more productive economy.

As for today's hearing, I know that the industries represented havesome very significant concerns about the impact of tax reform in general, and the Treasury's tax reform proposal in particular.

I look forward to hearing the witnesses specific objections, and the alternatives they have to offer. Those alternatives are key. While we will never have unanimous support for a particular tax plan, we must not let objections to specific aspects of that plan kill any hope for meaningful reform.

THE ECONOMIC IMPACT OF TAX REFORM ON COMMERCIAL REAL ESTATE

Prepared for the National Realty Committee

by

Price Waterhouse

April 5, 1985

I. EXECUTIVE SUMMARY

Background

The real estate industry provides the services of buildings and land that are a major element in the U.S. economy. More than half (53 percent) of all personal wealth and more than half (also 53 percent) of the value of business fixed capital in the U.S. is in the form of real estate. Also, each year a major share of investment in new property is in real estate. In 1983, for example, 54 percent of gross private domestic investment was in residential and non-residential structures, and non-residential structures comprised 27 percent of business fixed investment. About 5 million Americans are directly employed in the construction, sales, and operation of real estate properties.

The real estate industry raises capital, provides development and management knowhow, facilitates transactions and bears many of the risks associated with construction and ownership of real property. Ownership, even of non-residential real estate, is largely in the hands of individuals. Of the total of $1.6 trillion of non-residential structures in the U.S. in 1983, $628 billion, (38 percent) is owned by individuals, rather than corporations. The industry is both the provider of homes and work places and the investment vehicle of choice for many American households.

To determine the impact of proposed tax revisions on this industry, Price Waterhouse has conducted a study of the economics of real estate investment under a variety of alternative tax rules. Quantitative results are obtained from a newly-developed model of real estate taxation that takes into account more tax and market factors than analytic methods previously used for this purpose.

Taxation of Real Estate Under Current Law

The study first evaluates the treatment of real estate under present law as compared to investment in other types of property, such as business equipment. The study finds that the tax treatment of commercial real estate is currently less favorable than the treatment of investment in machinery and equipment, when each is financed by equal proportions of debt. For example, when a neighborhood shopping center development is financed 50 percent by debt, the current Federal income tax imposes a burden equal to 32 percent of the pre-tax rate of return. In the same circumstances, the present tax burden is only 8 percent of the rate of return from the purchase of industrial equipment. This difference in tax burdens is principally the result of the investment tax credit, which is not available for buildings.

In addition, the burden of state and local taxes also falls most heavily on real estate. In 20 states studied previously by Price Waterhouse, the average property tax burden on real estate used in business was 1.9 percent of property value per year, in addition to an average of 3.7 percent in sales taxes added to the cost of construction. By contrast, equipment is often either exempt from these taxes or taxed at lower rates. For example, the average property tax on equipment is 1.5 percent; the average sales tax on equipment is 2.5 percent.

Method of Analysis

The Price Waterhouse real estate tax model was used for an extensive analysis of selected provisions in three major tax reform proposals. These proposals are the Treasury proposal, the Bradley-Gephardt bill, and the Kemp-Kasten bill. The provisions are those that can have a major impact on real estate. The analysis was applied to examples of commercial real estate investment projects that are representative in the industry. These examples include shopping center developments, a rental housing development, and an office building development. The analysis is based on current financial conditions and consensus economic assumptions.

Tax changes that raise the taxation of real estate can produce a combination of three effects on the market for real estate. It can:

(1) reduce rates of return to investors in real estate

(2) raise the rents for real property; and

(3) lower the market value of existing or prospective real estate properties.

The Price Waterhouse model estimates the range of such market changes for various changes in the tax treatment of real estate investors.

Analysis of Reform Provisions

The baseline example for most of the quantitative comparisons is based upon a representative real estate investment. This investment, which is referred to for convenience as a "neighborhood shopping center", is financed 75 percent by a conventional 30-year mortgage at 12.5 percent interest. The investing partnership plans to hold the property for 15 years and to make a major improvement in the 10th year. The annual net rents derived from the property are initially 9.3 percent of the property value and are expected to grow by the rate of inflation, assumed to be 6 percent per year. Individual investors are assumed to be subject to the highest marginal tax rate -- 50 percent under current law. This example, while not a statistical "average", is intended to be representative of a real estate development offered to investment partnerships.

Quantitative analysis of tax reform proposals begins with estimates of the effects of particular provisions that could have a substantial impact on real estate. The results are presented in terms of the increase in rents required to maintain a rate of return, after tax, of 10 percent (in real terms). The first results are the impact on rents when each provision is incorporated separately in current law.

The stretched out depreciation deductions and more stringent capital gains provisions of the Treasury proposal, the "Real Cost Recovery System" (RCRS), and the Bradley-Gephardt bill, the "Simplified Cost Recovery System" (SCRS), are found to add substantially to the required rent, by 14.0 percent and 18.8 percent respectively. The Kemp-Kasten "Neutral Cost Recovery System" (NCRS), by contrast, would result in a slight reduction in rents (by 4.8 percent).

The single provision with the largest impact on real estate is the Treasury provision to index interest payments. If this provision alone were enacted, rents for the example project would have to increase by 31 percent to preserve profitability, even if mortgage rates fall as a result of reduced taxation of interest income to lenders. The study assumes a reduction of one full percentage point in lending rates accompanying the Treasury proposal to "index" interest. The increase in rents could be as much as 40 percent if mortgage rates are unaffected. A rent increase of 13 percent could pertain, even if mortgage rates fall by 3 full percentage points. Interest limitation (section 163d) and "at-risk" provisions could also add significantly to required rents.

Impact of the Treasury Proposal

Among the "big three" tax reform plans, the Treasury proposal would have the largest direct impact on real estate markets. This is the result of its less generous depreciation allowances and a number of restrictive provisions not included in the Congressional proposals. These include: (1) reducing the deduction for interest expenses as an adjustment, or "indexing", for inflation, (2) application of the "at risk" limitation on deductions that create losses, and (3) tightening of the limitation on the deductibility of interest.

Taken together, the above provisions, along with the proposed taxation of inflation-adjusted capital gains as ordinary income and the Treasury's proposed top tax rate of 35 percent, would result in a substantial increase in the tax burden associated with a typical real estate investment. This increased burden would be only partially offset by realistic reductions in interest rates that might result from the proposed partial tax exclusion of interest paid to lenders.

The net effect of the Treasury proposals, when fully effective, would be to require an increase in rents by as much as 25 percent to preserve the after-tax profitability of the example development.

Impact of Bradley-Gephardt

The Bradley-Gephardt Bill would also have an adverse impact on real estate, but less so than the Treasury proposal. As compared to the other proposals, Bradley-Gephardt would apply a greater tax on the gains from sale of a real estate project. To preserve rates of return in the face of higher taxes, the Bradley-Gephardt Bill would require an increase in rents of 14 percent for the same neighborhood shopping center development.

Impact of Kemp-Kasten

By contrast to the others, the Kemp-Kasten Bill essentially maintains the current tax treatment of real estate investment. In the example shopping center case, the change is in the direction of a slight improvement in the tax treatment of real estate. This is the net result of more generous depreciation allowances, as compared to present law, combined with a lower tax rate which reduces the value of those allowances. If the entire adjustment to the Kemp-Kasten system came through rent changes, rents would decline by 5 percent. In other examples presented below, however, Kemp-Kasten raises rents slightly.

Other Real Estate Examples

To test the sensitivity of these results to variations in the characteristics of real estate investment projects, three other examples have been defined. As compared to the example described earlier, these examples have varying amounts of debt financing, land value, renovation or capital additions, and number of years before a planned sale (i.e., holding period).

Example B has more debt, more complex financing terms, and a larger renovation/addition in the eighth year. These are more likely to be characteristics of a large "regional shopping center", hence this name is applied to the case for convenience. Such features are certainly not exclusive to regional centers, however. The significance of the examples is to show variation among real estate investments and should not be interpreted as a comparison of all shopping centers to all office buildings.

Example C has a smaller percentage of land value (as befits a high-rise building), more conventional financing, and a shorter holding period (10 years). This example is referred to as an "office building".

Finally, example D has the highest amount of debt financing and the shortest holding period. Unlike the other examples, which are all subject to the same current law tax rules, this example has current taxes computed under the depreciation and recapture rules for residential structures. For these reasons, Example D represents an "apartment building."

These four examples have been constructed to produce equal after-tax returns of 10 percent under current law. This facilitates comparisons among the examples. In reality, of course, rates of return may vary substantially from one project to another, but there is no evidence that shopping centers, say, are systematically higher yielding than offices or apartments.

The relative consequences of tax reform are similar among the four examples. Generally, the tax burdens are somewhat higher for examples B, C, and D as compared to the "neighborhood shopping center" case. The principal reason for this is the larger debt ratios, because leverage is treated less favorably under all of the tax reform programs.

If market resistance prevents rents from being raised by approximately the full amounts shown in previous examples, rates of return to investors in new projects will fall and market values of existing properties can also be expected to decline, reflecting the higher taxes that would be required of any prospective buyers. In the extreme case, if no rent increases were possible, the full impact of the tax changes would fall on investors, reducing real rates of return. For example, the rate of return to investors in an "office building" could fall from 10 percent to as little as 3 percent under Treasury, 2 percent under Bradley-Gephardt, and 9 percent under Kemp-Kasten. The "apartment" example could actually be reduced to a negative return under Treasury and Bradley-Gephardt. This in principally due to the harsher treatment of capital gains, especially for short holding periods, and limitations on interest deductions for projects with high leverage.

To make up for the higher taxes on future owners, the market value of an existing properties of this type could also fall. Reductions in market values could be as great as 40 percent, as in the "regional center" example under the Treasury proposal, if none of the higher tax can be passed along in higher rents and potential investors are unwilling to accept lower rates of return.

Conclusions

Unless the cost of capital is generally reduced by the overall effect of tax reform on the capital markets or other assets face still larger increases in tax, this study suggests a reduction in commercial real estate investment and construction as a result of either the Treasury or Bradley-Gephardt proposals. In addition, these tax changes would also very likely alter the ownership patterns for real property and the methods of financing real estate development. This probably means more ownership by institutions and corporations and less by individual investors.

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APARTMENT
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May 9, 1985

The Honorable John J. LaFalce
Chairman, Subcommittee on Economic
Stabilization, Banking, Finance
and Urban Affairs
U.S. House of Representatives
Washington, DC 20515

Dear ~~Chairman LaFalce~~: John,

As Executive Vice President of the National Apartment Association (NAA), I would like to thank you for the opportunity to express the views of the multihousing industry on the impact of the Treasury Department's tax reform proposal on real estate.

Enclosed you will find the April 23, 1985 testimony of Roger Greer, NAA's President, which I am submitting for the Record. In addition, I am also submitting a copy of the economic analysis commissioned by NAA which will supplement our testimony.

Representing over 200,000 owners, builders, managers and industry suppliers of over three million rental units and condominiums nationwide, the National Apartment Association is the voice for the multihousing industry. If you have any questions, or if you need any additional information, please feel free to contact me. My staff, Colleen Fisher, Director of Government Affairs, Charles H. Fritts, Tax and General Counsel, and their assistant, Marlana Chickos, offer their assistance to you and your Subcommittee in establishing a sound tax policy which will benefit the majority of Americans and stimulate economic growth.

Sincerely,

Scott L. Slesinger
Executive Vice President

Encls

MLC:sm

NATIONAL APARTMENT ASSOCIATION

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TESTIMONY

of

ROGER GREER

on behalf of the

NATIONAL APARTMENT ASSOCIATION

submitted to

SUBCOMMITTEE ON ECONOMIC STABILIZATION

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

on

THE IMPACT OF THE TREASURY DEPARTMENT'S TAX REFORM PROPOSAL
ON REAL ESTATE

April 23, 1985

Mr. Chairman and Members of the Subcommittee on Economic Stabilization, my name is Roger Greer and I am Division President of Johnstown American Companies in Houston, Texas. As President of the National Apartment Association * I would like to take this opportunity to commend you for holding these hearings on the impact of the Treasury Department's Tax Reform Proposal on the economy. We appreciate your exploration of the effects of tax reform on various segments of the economy to assure that any reform package that may be enacted will cause minimal disruption of normal economic activity.

In early 1984, NAA recognized that major tax reform legislation would become a priority issue in the 99th Congress. When the Treasury proposal was released in November 1984, NAA commissioned a study to assist the Congress in its consideration of the impact of the proposed changes in the tax code on the multihousing industry. Mr. Chairman, on behalf of NAA, I would ask to submit a copy of our study for the Record.

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* The National Apartment Association is a trade association representing over 200,000 owners, developers, managers and industry suppliers of over three million rental units and condominiums nationwide. The NAA is headquartered at 1101 14th Street, N.W., Suite 804, Washington, D.C. 20005.

Over many years, and certainly since World War II, affordable housing for all Americans has been a national priority whether it be owner-occupied or rented. However, as tax expenditure statistics clearly show, most incentives have been tilted sharply toward homeownership. In addition, there has also been a marked decline of direct subsidy programs for low income families, who overwhelmingly are renters.

Renters represent about 35 percent of all households in America. This translates to approximately 30 million households who choose to rent, or find it necessary to rent in order to meet their shelter needs. The median income of these households in 1983 was $13,400, compared to $24,400 for owner households. This typical renter household devotes 29 percent of its income to housing, as compared to an owner household that devotes 18 percent of its income to housing.

From an economic standpoint, if the current tax laws remain intact, an estimated 500,000 units will be added annually to the rental stock in the decade of the 1980s. In 1983, the rental housing industry generated $74 billion (excluding new construction), or 2.2 percent of the Gross National Product. In addition, the rental housing industry employs approximately one million full-time employees (excluding construction).

On a macroeconomic level, the construction of 450,000 multifamily rental units last year produced about 371,000 man years of employment for workers in the construction industry and other industries that directly provide goods and services for the multihousing industry. These workers earned $7.7 billion in wages and salaries in 1984. Multifamily rental construction actually accounts for the generation of $1.1 billion of federal, state and local taxes.

The tax treatment of rental housing vis a' vis single family housing, limits the price of rents irrespective of the costs of providing the rental housing. To a large extent, rents are limited by the minimum price of ownership housing with its built-in tax advantages of mortgage interest deduction that allows most homeowners to reach the threshold for itemizing deductions. This cornerstone incentive for homeownership is a critical governmental policy that discourages renting by all but the poorest households.

We, who are in the business of providing affordable rental housing for all Americans, must compete with owner-occupied single family homes, co-ops and condominiums. Because the income of our customers is limited and as a result of the tax incentives to own a house, rental housing cannot compete equally with other investments without some sort of subsidy. Unlike investments in businesses outside of the housing industry, supply and demand do not necessarily set prices in our industry. If costs go up, rents can only go up enough that they do not encourage renters to take advantage of homeownership, or at the other end of the spectrum make the housing unaffordable.

Mr. Chairman, political realities have forced the housing industry to look to the tax code as the only feasible vehicle for providing the assistance we need so that affordable housing is available for Americans. For instance, in 1984 over half of the multihousing units used tax-exempt bonds. Direct appropriation programs, especially for the poorest households will always be necessary. But today, the builders of multifamily housing have been forced to look to the tax code to provide affordable housing. We need your assistance in helping the Congress learn that "tax shelters" are not just loopholes for the wealthy to avoid paying taxes. But in fact, these "shelters" make it possible to build housing for low and moderate income Americans that would be economically impossible without the tax incentives provided through the code. Without tax incentives, rental housing will not be able to attract investment capital.

These tax incentives including the Accelerated Cost Recovery System of depreciation (ACRS), the 60 percent capital gains exclusion, full deductibility of the interest expense, exemption of real estate from the at-risk rules, and current tax status of limited partnerships have been the lifeblood of the industry. The preservation of these tax incentives is essential to the survival of the multihousing industry.

NAA agrees that every industry must pay its share in attacking the federal deficit. However, we feel the real estate industry is paying a disproportionate share of the burden. In fact, the Treasury Department's tax reform proposal released last November contains provisions which, if enacted into law, would substantially alter how we in the multihousing industry will supply rental housing for this country. Under the proposal, the major changes which would impact real estate are the following:

* ACRS AND INVESTMENT TAX CREDIT - The current depreciation schedule for real estate would be repealed. Instead, the basis of depreciable assets would be indexed for inflation and depreciation allowances for tax purposes would be set at three percent per year.

* AT RISK - Real estate would be subject to the at-risk rules.

* INSTALLMENT SALES - The use of installment sales for certain transactions would be denied.

* TAXATION OF PARTNERSHIPS - Any partnership consisting of 35 limited partners, or more would be taxed as a corporation.

* CAPITAL GAINS - The capital gains exclusion would be repealed.

* TAX EXEMPT FINANCING - The current exemption for tax exempt bonds, including industrial development bonds (IDBs) would be eliminated.

* INTEREST EXPENSE - There would be a $5,000 cap on the interest expense deduction and this would be adjusted for inflation.

* CONSTRUCTION PERIOD INTEREST AND TAXES - The construction period interest and taxes would be amortized over the life of the property, rather than over ten years.

The economic analyses commissioned by NAA focused on several of the provisions in the Treasury proposal, including capital gains, marginal rates, interest expense, depreciation and construction period interest and taxes. If enacted into law, these provisions would affect investment in rental housing, rent rates and property values.

The following is a summary of the major effects on the rental housing industry if these provisions in the Treasury Proposal are adopted:

- To maintain the current yield for investments in multifamily property, rents on properties would have to increase by as much as 44 percent on properties that are constructed after enactment of the Treasury proposal.

- Investor/owners could experience declines in the value of their holdings of as much as 28 percent, unless rents increase significantly above inflation.

- New production of rental housing would decline sharply, resulting in a housing shortage.

- The lowering of the tax brackets and the expected lower tax for rental household families would be quickly absorbed by rent increases, thereby leaving renter households with less money for non-housing expenditures.

- The decline in rental real estate values could have a significant negative impact on loan to value ratios. This increases the risk to the current portfolio of lenders.

In light of our national priority to provide decent and affordable housing to all Americans, NAA urges Congress to preserve the tax incentives for capital formation in the multihousing industry in any overhaul of the current tax system. These incentives have kept the industry alive and have helped make the United States the best-housed nation in the world. They should be preserved and be strengthened.

Private capital formation is essential to economic growth. The multihousing industry had just begun to reap the benefits of the positive changes enacted by Congress in 1981. The Economic Recovery Tax Act of 1981 provided some security to the rental housing industry by instilling tax incentives to the Internal Revenue Code, which were designed to stimulate the economy. However, since that time, Congress has consistently taken away these incentives through the Tax Equity and Responsibility Act of 1982 and the Deficit Reduction Act of 1984. The trend seems to be to focus on the real estate industry to bear an overwhelming and unfair portion of the burden of the federal deficit.

Capital investment in real estate is very risky. In the multifamily area, there are very unique risks including political interference with rights of ownership, such as rent control, local taxation at discriminatory rates, substantial tax preferences for ownership housing, and bankrupcy laws that treat rents differently than other debts.

Frequent modifications of the tax code create uncertainty in the market and prevent long-term planning, an integral component of real estate investing. Furthermore, since the return on investments in rental housing is diminishing due to increasing maintenance costs and other factors, investors will begin to look elsewhere for investments that are more fruitful and more secure. The rental housing industry cannot withstand and survive continued changes in the tax code which draw more and more potential capital from the industry.

Mr. Chairman, the multihousing industry has already begun to feel the effects of the Treasury tax reform proposal. Our members across the country have witnessed an increasing loss in the vitality in the industry under the shadow of further detrimental changes to the tax code. On behalf of the National Apartment Association and also of the residents we serve, I urge the Subcommittee to examine and recognize the impacts of each of the provisions in the Treasury Department's tax reform proposal and to work to preserve the essential tax incentives which have been the mainstay of the industry.

The NAA would be pleased to offer our assistance in establishing a coherent effort to assure that any tax reform package which may come before the Congress actually promotes "Fairness, Simplicity, and Economic Growth."

Mr. Chairman and Members of the Subcommittee, I thank you for allowing me the opportunity to express our views.

THE IMPACT ON HOUSING
OF THE
TREASURY DEPARTMENT PROPOSAL
ENTITLED
"TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH"

NATIONAL APARTMENT ASSOCIATION
WASHINGTON, D.C.

MARCH 1985

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INTRODUCTION

The National Apartment Association (NAA) is a trade association representing more than 45,000 owners, developers, builders and managers of over 2.4 million apartment and condominium units across the country. NAA is the only trade association devoted exclusively to the needs and problems of the multifamily rental housing industry.

In early 1984, NAA recognized that major tax reform legislation would become a priority issue in the 99th Congress. When the Treasury proposal was released in November 1984, NAA commissioned a study to assist the Congress in its consideration of the impact of the proposed changes in the tax code on multifamily housing.

The study was designed to evaluate the cumulative and individual impacts of the provisions of the Treasury Department's tax reform package released on November 27, 1984 entitled, "Tax Reform for Fairness, Simplicity and Economic Growth." The basic analysis of the Treasury proposal on rental housing was done by William B. Brueggeman, Southern Methodist University, Dallas, Texas.

EXECUTIVE SUMMARY

The study analyzes the impact of the Treasury proposal on the rental housing industry. The study uses a typical apartment complex constructed in a suburban community. It compares the rent levels, property values and rates of return under the present tax structure and under the Treasury proposal. The study analyzes the Treasury proposal under inflation rates of four percent and six percent and holding periods of eight and eighteen years. In addition, comparisons were made under interest rate environments of 10, 11, 12, 13 and 14 percents.

The following is a summary of the major effects if the Treasury proposal is adopted:

- To maintain the current yield for investments in multifamily property, rents on properties would have to increase by as much as 44 percent on properties that are constructed after enactment of the Treasury proposal.

- Investor/owners could experience declines in the value of their holdings of as much as 28 percent unless rents increase significantly above inflation.

- New production of rental housing would decline sharply, resulting in a housing shortage.

- The lowering of the tax brackets and the expected lower tax for rental household families would be quickly absorbed by rent increases, thereby leaving renter households with less money for non-housing expenditures.

- The decline in rental real estate values could have a significant negative impact on loan to value ratios, thereby increasing the risk to the current portfolios of lenders.

In order to compete for investment capital, owners of rental housing would have to increase their cash flows. To make up for the loss of tax incentives, there would be significant pressure to raise rents in multifamily housing properties that are constructed or purchased after enactment of the Treasury proposal. In markets where rents could not be raised immediately because there is a present oversupply, the values of properties would decline. Because of these factors, the industry would not be able to attract investment capital and construction would stop. The resulting shortage of rental housing would put further upward pressure on rents and make rental housing unaffordable to the majority of the 30 million American households who rent.

The rental housing industry makes a significant contribution towards housing a large number of Americans and to the general economy. Some of the significant statistics are:

- Approximately 30 million households, or 60 million Americans, rent. Renters represent about 35 percent of all households in America.
- An estimated 500,000 units will be added annually to the rental stock in the decade of the 1980s.
- In 1983, the median renter household income was $13,400, compared to $24,400 for owner households.
- In 1983, 55.7 percent of renter households had incomes of under $15,000 compared to 22.4 percent for owner households.
- The typical renter devotes 29 percent of income for housing versus 18 percent for owners.
- In 1983, the rental housing industry generated $74 billion (excluding new construction), or 2.2 percent of the GNP.
- The rental housing industry employs approximately one million full-time employees (excluding construction).
- Total value of our country's existing rental housing stock is approximately $1 trillion.

FRAMEWORK OF THE STUDY

The analysis of the potential impact of the major provisions of the Treasury proposal on the rental housing industry was conducted through a present value discounted cash flow model. (A presentation of the model is given in Appendix 2). A Base Case utilizing development assumptions for a typical garden walk-up apartment complex under current tax laws was developed. A series of simulations of the model were undertaken to estimate the cumulative impact of the Treasury proposal and the relative individual impacts of certain provisions.

Provisions Analyzed:

The following are the provisions in the Treasury proposal that were measured in Professor Brueggeman's simulations that would, if enacted into law, affect investment in rental housing, rent rates and property values.

1. CAPITAL GAINS - Taxation of capital gains at ordinary rates and adjustment of the basis of the property for inflation.

2. MARGINAL RATES - Reduction in personal tax rates to a maximum of 35 percent.

3. INTEREST EXPENSE - Limitation of the deduction of the interest expense by excluding that portion that represents inflation.

4. DEPRECIATION - Reduction of depreciation allowances to three percent per year and index the basis of the property for inflation.

5. CONSTRUCTION PERIOD INTEREST AND TAXES - Amortization of the construction period interest and taxes over the life of the property, rather than over ten years.

Due to the broad scope of the Treasury proposal and the numerous provisions which it contains, the study examined only the major provisions of the Treasury proposal that are readily quantifiable. Therefore, the study did not take into account the provisions in the Treasury proposal which would subject real estate to the "at risk" rules; tax partnerships with more than 35 limited partners as corporations; cap interest deductions at $5,000; repeal tax-exempt financing; and repeal the historic and rehabilitation tax credits. If any or all of these items were adopted, they would further reduce yields which owners of rental housing would receive.

A comparison of the current tax law and the proposed changes is given in Table 1.

TABLE 1

Provision		Current Law	Treasury Proposal
1.	MAXIMUM PERSONAL TAX RATE	50%	35%
2.	MAXIMUM CAPITAL GAINS RATE	20%	35%
3.	INTEREST EXPENSE	FULLY DEDUCTIBLE	DEDUCTION INDEXED FOR INFLATION
4.	DEPRECIATION ALLOWANCES	ACRS 18 YEARS 175 % DECLINING BALANCE	3% PER YEAR, BASIS ADJUSTED FOR INFLATION
5.	CONSTRUCTION PERIOD INTEREST AND TAXES	10 YEAR AMORTIZATION	AMORTIZATION OVER LIFE OF BUILDING

Other Treasury proposals that would effect rental housing not measured in this study.

	CURRENT LAW	TREASURY PROPOSAL
"AT RISK" RULES	NOT APPLICABLE TO REAL ESTATE	APPLIED TO REAL ESTATE
INTEREST EXPENSE	FULLY DEDUCTIBLE	CAP OF $5,000 PLUS INVESTMENT INCOME
TAXATION OF LIMITED PARTNERSHIP WITH MORE THAN 35 LIMITED PARTNERS	TAXED AS PARTNERSHIP	TAXED AS CORPORATION
LOW INCOME REHABILITATION EXPENSES	5 YEAR AMORTIZATION	AMORTIZATION OVER LIFE OF EXPENSES
TAX EXEMPT BONDS FOR RENTAL HOUSING	PERMITTED	PROHIBITED
REHABILITATION AND HISTORIC TAX CREDIT	PERMITTED	PROHIBITED

TABLE II

BASE CASE ASSUMPTIONS FOR THE STUDY

I. General:

- garden walkup apartment complex in suburban location
- inflation rates considered = four and six percent
- holding periods = eight years and eighteen years
- required after tax rate of return (ATIRR) = fifteen percent
- selling expenses as percent of sale price = four percent
- development period - two years
- real rate of depreciation = 1.5 percent per year
- inflation in property values = 4.5 percent and 1 percent respectively

II. Total Development Costs:

- hard costs = 70 percent
- soft costs = 12 percent
- cost of land = 10 percent
- profit and/or syndication = 8 percent

III. Financing:

- interest rate = 14 percent
- term 25 years
- financing fees = two percent each for interim and permanent loans
- mortgage loan = 80 percent of land, hard costs, soft costs, and interim interest
- equity investment = hard costs, soft costs, interest, profit and syndication, less mortgage loan

IV. Operating Assumptions:

- operating expenses = 35 percent of effective income
- increase in rent at rate of 6 percent and 4 percent respectively

V. Tax Assumptions:

- tax rate = 50 percent
- capital gains tax rate = 20 percent
- depreciation rate for tax purposes = 175 percent of straightline

Table III shows the estimates for rents, project value and after-tax internal rate of return (ATIRR) for the typical project that was utilized in the Base Case. A series of simulations of the estimated impact of the Treasury proposal from the Base Case was undertaken.

Table III assumes that the value of the property equals the total development costs (TDC), including the profit earned by the developer. The baseline assumptions provide for a 15 percent after tax internal rate of return (ATIRR) to the investor.

TABLE III

Estimates from Base Case Assumptions
Present Tax Law

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of Total Development Cost	19.0	14.7	17.5	14.0
B. Property Value = Total Development Cost (TDC)	100	100	100	100
C. After Tax Internal Rate of Return (ATIRR)	15.0	15.0	15.0	15.0

CUMULATIVE EFFECTS OF THE TREASURY PROPOSAL

The most meaningful analysis of the impact of the Treasury proposal is its overall cumulative effects on rents, project values and rates of return.

In measuring the cumulative effects of the Treasury proposal, various levels of interest rates were chosen. There is some basis for expecting a decline in interest rates due to the impact of the non-taxation of the inflation portion of interest payments on lenders.

TABLES IV A through E analyze the cumulative effects of the Treasury proposal under different mortgage interest rates, 14 percent to 10 percent, respectively. Line A, Rental income as a percent of TDC reflects the higher rent as a percentage of TDC, required to maintain 15 percent ATIRR. Line B in the tables demonstrates the rent increases over and above inflation, required to maintain the 15 percent ATIRR. If rents do not increase, Line C shows the corresponding reductions in property values. Line D shows the ATIRR as a result of the tax law changes before any rent increases.

It is important to emphasize that the rent increases required are in addition to the increases in the inflation rate.

TABLE IV A
Cumulative Effects of Treasury Proposal
Mortgage Interest Rate = 14 percent

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR OF 15%	25.8	21.2	23.4	19.1
B. % Change in rent required to produce ATIRR of 15%	35.8	44.2	33.7	36.4
C. % Change in value from base before any rent increase above assumed rate of inflation	-24.2	-28.0	-22.4	-23.7
D. ATIRR before any rent increase above assumed rate of inflation	7.1	8.2	9.1	10.0

Under TABLE IV A, assuming an eight year holding period and six percent inflation, rents would have to increase by 44.2 percent over inflation to maintain a 15 percent ATIRR. If rent levels remain unchanged, the value of the property would decline by 28.0 percent.

The following TABLES IV B through E demonstrate the cumulative impact under interest rate scenarios of 13, 12, 11, and 10 percent, respectively. As interest rates decline, the degree of the impact lessens. They show that even with an assumption of an inflation rate of four percent, the impacts of the Treasury proposal on investment in rental housing as well as rents are substantial.

TABLE IV B

Cumulative Effects of the Treasury Proposal
Mortgage Interest Rate = 13 percent
(1 percentage point decline in interest rate
from Base Case)

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	24.0	19.4	21.8	17.7
B. % Change in Rent required to produce ATIRR of 15%	26.3	32.0	24.6	26.4
C. % Change in value from base before any rent increase above assumed rate of inflation	-19.0	-22.3	-17.6	-18.6
D. ATIRR before any rent increase above assumed rate of inflation	9.2	10.0	10.6	11.5

TABLE IV C

Cumulative Effects of Treasury Proposals
Mortgage Interest Rate = 12 percent
(2 percentage point decline in interest rate from Base Case)

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	22.1	17.7	20.3	16.4
B. % Change in rent required to produce ATIRR of 15%	16.3	20.4	16.0	17.1
C. % Change in value from base before any rent increase above assumed rate of inflation	-13.0	-15.6	-12.7	-13.1
D. ATIRR before any rent increase above assumed rate of inflation	11.3	11.8	12.1	12.7

TABLE IV D

Cumulative effects of Treasury Proposal
Mortgage Interest Rate = 11 percent
(3 percentage point decline in interest rate
from Base Case)

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental increase as % of TDC required to produce ATIRR of 15%	20.3	16.0	18.8	15.1
B. % Change in rent required to produce ATIRR of 15%	6.8	8.8	7.4	7.9
C. % Change in value from base before any rent increase above assumed rate of inflation	-5.3	-6.9	-5.7	-5.9
D. ATIRR before any rent increase above assumed rate of inflation	13.6	13.7	13.7	14.0

TABLE IV E

Cumulative Effects of Treasury Proposal
Mortgage Interest Rate = 10 percent
(4 percentage decline in interest rate from Base Case)

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	18.4	14.3	17.3	13.7
B. % Change in rent required to produce ATIRR of 15%	-3.2	-2.7	-1.1	-2.1
C. % Change in value from base before any rent increase above assumed rate of inflation	1.8	1.6	0	0.5
D. ATIRR before any rent increase above assumed rate of inflation	15.7	15.5	15.3	15.3

IMPACT ON RENTERS AND VALUE OF RENTAL STOCK

The applications of Professor Brueggeman's work to the potential impact on renters places the Treasury proposal in a broader context. A majority of renter households are already in a tenuous housing affordability situation. The median income to housing expense ratio for renters was 29.9 percent in 1983, compared to 18 percent for owner occupants. The median income of renters was only $13,400 in 1983, compared to $24,400 for owners. The Treasury Department has estimated that if its tax reform proposal is enacted into law there would be a reduction in the federal income tax liability of many individuals. For a household with $10,000 in income, its tax liability would be reduced by $50 per year. Currently, households in that bracket are devoting about $266, or 32 percent, of their monthly income to rent. It would take only a little over $4 per month in a rent increase to eliminate the tax benefits of the Treasury proposal, an increase of only 1.5 percent. For a typical renter with income of $20,000 per year the Treasury's estimated annual tax savings of $200 would be offset by a 4.7 percent increase in their $350 per month rent.

Tables V,and VI give details on the monthly housing costs as a share of income, and the income levels of renters versus owners. Nearly four out of ten renters devoted more than 35 percent of their income to housing expenses compared, to one in less than seven owners. The principle reason for the large number of renters devoting greater shares of their incomes to housing is their lack of income. Nearly six out of ten renter households had incomes of less than $15,000 in 1983. At the same time, less than one in four homeowners had incomes of less than $15,000, and 60 percent of these households did not have a mortgage payment. At the higher end of the income scale, less than three percent of all renter households had incomes of $50,000 or more, compared to about 17 percent for owner households.

TABLE V

Housing Expenses as a Percent of Household Income (1983) Renter versus Owner Households

Housing Expenses as % of Income	Share of Renters	Share of Owners
Less than 10%	3.5%	19.6%
10-14%	9.7	20.7
15-19%	13.5	17.1
20-24%	14.3	12.8
25-34%	20.8	15.0
35-49%	14.7	7.7
50-59%	6.0	2.1
60% +	17.5	5.0
Total	100%	100%
Median Income to Housing Expenses Ratio	29%	18%

TABLE VI

Household Income and Median Housing Expenses as a Percent of Household Income (1983) Renter versus Owner Households

	Renters		Owners	
Income	% of total	median gross rent as a % of income	% of total	median housing expenses as a % of income
<10,000	37.5	56	13.0	41
10-14,999	18.2	32	9.4	24
15-19,999	13.6	26	9.3	29
20-24,999	9.5	21	9.8	20
25-34,999	12.1	18	21.2	17
35-49,999	6.3	14	20.2	14
50-74,999	2.1	12	11.8	12
>75,000	0.7	10	5.3	9
Total	100.0		100.0	
Median Income	$13,400		$24,400	

Source: U.S. Bureau of Census and
HUD 1983 Annual Housing Survey

APPENDIX I

IMPACT OF INDIVIDUAL COMPONENTS OF TREASURY PROPOSAL

The major provisions of the Treasury proposal were individually simulated by Professor Brueggeman to isolate their relative impacts on the rental housing industry. Each of the individual components of the Treasury proposal was analyzed separately, holding other considerations constant with current tax law. The provision to require indexing of interest expenses was also simulated along with the potential declines in interest rates that might result should the Treasury proposal be enacted into law.

The results of the individual simulations cannot be added together and directly compared to the cumulative impacts which were detailed in the main report. The cumulative proposal simulations allow for interaction between the various components. The results were based on estimates of the impact of each provision of the Treasury proposal and are subject to rounding errors.

The summary of simulation results of the components of the Treasury proposal are given in Appendix Table 1. They show that unless interest rates decline, the provision to index mortgage interest deductions would have the most significant impact on rental housing. For purposes of comparison, six percent inflation was used for a project with an eight year holding period. The repeal of the capital gain exclusion would have the second most important impact, followed by the reduction in the maximum ordinary income, marginal tax rate. The change in the treatment of depreciation would also be significant. Among the provisions measured by this study, the repeal of the ten year amortization of construction period interest and taxes would have the least impact. This was expected because construction period interest and taxes represent a small proportion of total development costs.

APPENDIX
TABLE 1

Summary of Estimated Impacts From Base Case Rent Levels of Individual Elements of Treasury Proposal

Holding Period	8 years
Inflation Rate	6 %
Mortgage Interest Rate	14 %

Treasury Proposal	Change in Rents Required To Produce ATIRR of 15%
Reduce Marginal Rate to 35% and Repeal Capital Gains Exclusion	25.9%
Repeal of Capital Gains (Taxed at 35%)	16.3%
Reduced Maximum Marginal Rate on Ordinary Income to 35%	13.6%
Indexing of Mortgage Interest Expense	23.9%
Depreciation Limited to 3% Plus Indexing for Inflation	6.6%
Capitalization and Depreciation of Construction Period Interest and Taxes	1.5%

Appendix Tables 2 through 8 provide detailed impacts of the individual components of the Treasury proposal for holding periods of eight and eighteen years at inflation rates of four and six percent.

APPENDIX
TABLE 2

Change in Base Case to Reflect
Changes in Ordinary and Capital Gains Tax Rates to 35%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR OF 15%	21.8	18.5	18.9	15.8
B. % Change in rent required to produce ATIRR of 15%	+14.7	+25.9	+ 8.0	+12.9
C. % Change in value from base before any rent increase above assumed rate of inflation	-11.8	-19.1	- 6.4	- 9.9
D. ATIRR before any rent increase above assumed rate of inflation	11.1	10.0	13.2	12.9

Appendix Table 2 shows the impact of the repeal of the 60 percent capital gains exclusion calculated at a marginal tax bracket of 35 percent and the reduction of the maximum ordinary tax rate to 35 percent. Assuming six percent annual inflation over an eight year holding period, rents would have to increase over inflation by 25.9 percent to maintain a 15 percent ATIRR. If rents do not rise above the six percent inflation rate, the value of the property would decline by 19.1 percent and the ATIRR would decline to ten percent.

APPENDIX
TABLE 3

Change in Base Case to Reflect Change In Capital Gains Tax Rate to 35%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental incomes % of TDC required to produce ATIRR of 15%	20.9%	17.1%	18.2%	14.9%
B. % Change in rent required to produce ATIRR of 15%	+10.0	+16.3	+ 4.0	+ 6.4
C. % Change in value from base before any rent increase above assumed rate of inflation	- 7.2	-10.9	- 2.9	- 4.5
D. ATIRR before any rent increase above assumed rate of inflation	12.8	12.5	14.2	14.1

Appendix Table 3 shows the impact of the repeal of the capital gains exclusion and taxing that capital income at a 35 percent marginal tax rate. Assuming a six percent inflation rate over an eight year holding period, rents would have to rise by 16.3 percent over inflation to maintain a 15 percent ATIRR. If rents do not rise above the 6 percent annual inflation rate the property would decline in value by 10.9 percent and the ATIRR would drop to 12.5 percent.

APPENDIX
TABLE 4

Change in Base Case to reflect change in Ordinary Income Tax Rate to 35%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental incomes as % of TDC required to produce ATIRR of 15%	20.4%	16.7%	18.4%	15.1%
B. % Change in rent required to produce ATIRR of 15%	+7.4	+13.6	+ 5.1	+ 7.9
C. % Change in value from base before any rent increase assumed inflation rate	- 5.8	+10.4	- 3.9	- 6.2
D. ATIRR before any rent increase above assumed rate of inflation	13.2	12.6	14.0	13.8

Appendix Table 4 shows the estimated impact of dropping the highest marginal tax rate from the current 50 percent to 35 percent, only assuming a six percent annual inflation rate with a project holding period of eight years, rents would have to rise 13 percent over inflation to maintain a 15 percent ATIRR. If rents do not rise above the six percent inflation rate, the value of the property would decline by 10.4 percent and the ATIRR would decline to 12.6 percent.

APPENDIX
TABLE 5A
Change in Base Case to Reflect Indexing of Mortgage Interest Expense
Mortgage Rate = 14%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	22.8%	18.2%	20.7%	16.8%
B. % Change in rent required to produce ATIRR of 15%	+20.0	+23.9	+18.3	+20.0
C. % Change in value from base before any rent increase above assumed rate of inflation	-11.6	-13.3	-10.2	-10.9
D. ATIRR before any rent increase above assumed rate of inflation	11.1	11.7	11.9	12.6

Tables 5A through 5E demonstrate the impact of indexing the mortgage interest expense deduction for inflation at different interest rates. The interest rates used in Tables 5A - E are 14, 13, 12, 11 & 10 percent, respectively. The inability to deduct the entire interest expense reduces the ATIRR. The loss of the value of the deduction would require increases in rent in order to maintain the 15 percent ATIRR (Base Case).

APPENDIX
TABLE 5B

Change in Base Case to Reflect Indexing of Mortgage Interest Expense
Mortgage Rate = 13%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	21.0%	16.5%	19.2%	15.5%
B. % Change in rent required to produce ATIRR of 15%	+10.5	+12.2	+ 9.7	+10.7
C. % Change in value from base before any rent increase above rate of inflation	- 6.5	- 7.5	- 5.6	- 6.0
D. ATIRR before any rent increase above assumed rate of inflation	12.9	13.3	13.3	13.6

APPENDIX
TABLE 5C

Change in Base Case to Reflect Indexing
of Mortgage Interest Expense
Mortgage Rate = 12%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	19.3%	14.9%	17.7%	14.2%
B. % Change in rent required to produce ATIRR of 15%	+ 1.6	+ 1.4	+ 1.1	+ 1.4
C. % Change in value from base before any rent increase above assumed rate of inflation	- .9	- .8	- .7	- .7
D. ATIRR before any rent increase above assumed rate of inflation	14.7	14.8	14.8	14.8

APPENDIX
TABLE 5D
Change in Base Case to Reflect Indexing of Mortgage Interest Expense
Mortgage Rate = 11%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	17.4%	13.2%	16.2%	12.8%
B. % Change in rent required to produce ATIRR of 15%	- 8.4	-10.2	- 7.4	- 8.6
C. % Change in value from base before any rent increase above assumed rate of inflation	+ 5.9	+ 7.0	+ 4.9	+ 5.4
D. ATIRR before any rent increase above assumed rate of inflation	16.7	16.5	16.3	16.1

APPENDIX
TABLE 5E

Change in Base Case to Reflect Indexing
of Mortgage Interest Expense
Mortgage Rate = 10%

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	15.7%	11.6%	14.9%	11.8%
B. % Change in rent required to produce ATIRR of 15%	-16.3	-20.4	-14.2	-15.7
C. % Change in value from base before any rent increase above assumed rate of inflation	+13.0	+15.5	+10.5	+11.5
D. ATIRR before any rent increase above assumed rate of inflation	18.5	18.1	17.7	17.3

APPENDIX
TABLE 6

Change in Base Case to Reflect Depreciation Allowances at 3% per Year and Adjust Basis for Inflation

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of TDC required to produce ATIRR of 15%	21.4%	16.0%	20.3%	15.8%
B. % Change in rent required to produce ATIRR of 15%	+12.6	+ 8.8	+16.0	+12.9
C. % Change in value from base before any rent increase above assumed rate of inflation	- 9.5	- 6.6	-11.6	- 9.1
D. ATIRR before any rent increase above assumed rate of inflation	12.8	13.9	12.6	13.6

Appendix Table 6 shows the impact of reducing the property depreciation allowances to three percent per year plus indexing the basis of the property for inflation. Assuming a six percent annual average rate of inflation over an eight year holding period rents would have to increas 6.6 percent to maintain a ATIRR of 15 percent. It would require very high inflation rate for indexation to offset the impact of the reduction in depreciation allowances.

APPENDIX
TABLE 7

Change in Base Case to Reflect Capitalization and Depreciation of Construction Period Interest & Taxes

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental income as % of required to produce ATIRR of 15%	19.6%	15.1%	18.0%	14.3%
B. % Change in rent required to produce ATIRR of 15%	+ 3.2	+ 2.7	+ 2.9	+ 2.1
C. % Change in value from base before any rent increase above assumed rate of inflation	- 1.5	- 1.5	- 1.5	- 1.3
D. ATIRR before any rent increase above assumed rate of inflation	14.4	14.6	14.6	14.7

Under current law, construction period interest and taxes are amortized over a ten year period rather than amortized over the life of the property. The repeal of this provision would require a 2.7 percent rent increase, assuming a six percent inflation and an eight year holding period, if rents are not increased.

APPENDIX II
THE ANALYTIC FRAMEWORK

To analyze the effects of changes in tax legislation, Brueggeman used a variation of the present value framework he previously had employed in 1977 and 1982, and that of de Leeuw and Ozannee in 1979. In the framework, cash flows related to development costs (adjusted for cash flows related to development phase), after-tax cash flows from annual operating revenues less expenses, and after-tax cash flows from the sales of the property in some future year are discounted by a required after-tax rate of return until equality between inflows and outflows is achieved. More specifically, the after-tax rate of return (K) on equity invested in a real estate income property investment can be determined from:

$$\sum_{i=1}^{d} \frac{(TDC_i - DF_i)}{(1 + K)^i} = \sum_{i=1}^{s} \frac{(R_i - O_i - I_i - P_i) - (R_i - O_i - I_i - D_i - A_i)\, t_o}{(1 + K)^i}$$

$$+ \frac{V_s - B_s - S_s - G_s t_g - RC_s\, t_o}{(1 + K)^s}$$

TDC = total development costs, including land (L)

DF = development financing

d = end of development period

s = holding period in years

R_i = rental income in year i

O_i = operating expenses including property taxes, in year i

I_i = interest on mortgages paid in year i (adjusted for inflation under Treasury proposal)

D_i = tax depreciation taken in year i

A_i = amortization of construction period interest and property taxes (becomes 0 in Treasury proposal and is included in depreciable basis)

t_o = marginal ordinary income tax rate

t_s = marginal capital gains tax rate

P_i = principal portion (amortization) of the loan payment in year i

V_s = estimated value and selling price in year s

S_s = selling and other transaction costs in year s

G_s = capital gain, net of selling costs (S_s) resulting from sale in year s

RC_s = net excess depreciation (accelerated over straightline) which is recaptured upon sale (if relevant)

B_s = balance of mortgage in year s

K = nominal after-tax discount rate on equity investment in a property held for s years

In the long run, we would expect that the present value of after-tax cash flows, when set equal to the present value of equity invested in the property would result in the marginal investor earning a competitive, after-tax rate of return (K) if the property is held for s years. The holding period (s) and the value of the property when sold (V_s) would be such that a buyer in year 's' would also earn the same after-tax rate of return on equity from the same remaining economic life of the property. Similarly, if the after-tax rate of return is given, the Equation can be rearranged and rents (R) can be determined given estimates of other variables.

In the analysis, the total development costs (TDC) are equivalent to the demand price for a project. Then, given a value of 'K' and inputs for land, development, and operating expenses, capital gains treatment (relevant under current tax legislation) and transactional cost, the initial level of rents (R) necessary for investors to earn a required after-tax rate of return on equity can be ascertained. After this equilibrium relationship between R and TDC is established, the market effects of changes in relevant tax variables can be examined for rental properties. By making appropriate changes in the equation for tax variables in question, a new equilibrium relationship between R and TDC is established given that the same after-tax rate of return must be earned by the investor. The short run impacts on value and after-tax internal rates of return can be estimated from the simulation, assuming rents do not rise to offset the tax law changes. The longer term impacts would be determined by market adjustment forces.

To analyze the impact of tax changes on the residential rental property, a Base Case example of a recently developed rental property under current tax laws was established. The Base Case assumptions shown in Table II in the body of the text were produced from a representative sample of properties.

The simulations of the impact of the effects of the proposed changes were run under different assumptions regarding inflation, interest rates, and holding periods.

IMPACT OF TAX SIMPLIFICATION ON THE INSURANCE INDUSTRY

WEDNESDAY, MAY 8, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met at 10 a.m. in room 2128, Rayburn House Office Building, Hon. John L. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Carper, Shumway, Wortley, Ridge, Dreier, McCandless, and McMillan.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

This is the fourth in a series of hearings the Subcommittee on Economic Stabilization is holding on the sectoral consequences of the Treasury Department's tax simplification plan. In previous hearings we have examined the potential impact of the plan on overall economic growth, manufacturing industries, and the construction and real estate industries. Today we will inquire into the insurance industry, and tomorrow the banking industry. If anybody thinks we don't have an industrial policy with respect to the insurance industry now, wait until the end of these hearings.

The strong views I am sure we will hear expressed this morning will only confirm the central role the Federal Tax Code has played in shaping the structure of the insurance industry in the United States.

An additional purpose in holding this hearing, I hope, will be to clarify what all agree are a very complex, little understood, yet very important set of tax provisions affecting the life insurance and the property and casualty insurance industries.

The life insurance industry has expressed strong concern about the Treasury proposal to tax as interest income the yearly increase in the cash value of a life insurance policy, the so-called "inside buildup." The industry argues that a policyholder, like a homeowner, should not be taxed on the increased values of a life insurance policy which have not been realized. The Treasury, as well as many economists, believe there is no sound reason to differentiate the interest income from an insurance policy from the taxable interest income on other forms of savings.

Among the many other provisions of the Treasury plan that would affect life insurance, the industry has expressed particular concern about proposals to tax the inside buildup on deferred annuities, and the deferred income and interest income from 401(k) profit-sharing plans, to eliminate the exclusion of the first $50,000 of employer provided group term life insurance, and to place a limit on employer contributions to employee health care benefit plans.

The property and casualty insurance industry has one concern that exceeds all others: The Treasury proposal to tax the income which the industry earns on the loss reserves it must set aside when a claim is made. This proposal, the industry maintains, would jeopardize the stability of many companies by leaving them with insufficient reserves to cover claims. The Treasury contends, however, that there is no reason the investment income the industry earns on these reserves should escape taxation.

Here to address these issues today is an exceptional panel of industry spokesmen and critics: the Honorable Richard Schweiker, president, American Council of Life Insurance; T. Lawrence Jones, president, American Insurance Association; and Mr. Robert Hunter, president, National Insurance Consumer Organization.

Before we begin today's hearings, I want to say how pleased I am that we do have before us such a distinguished panel. In Mr. Schweiker we have before us, first and foremost, my former Congressman when I spent 3 years at Villanova School of Law in Villanova, PA, then U.S. Senator, then almost Vice-Presidential candidate of the United States, and then Secretary of either HEW or HHS, or both—I've forgotten, Dick—and now president of the American Council of Life Insurance.

Although I haven't talked to Mr. Jones very much, it's been my pleasure to work with his outstanding assistant, Mavis Walters. Many years ago, we had many go-arounds on the issue of product liability and while we may not have agreed on all the issues, I never had any more respect for anybody in the insurance industry.

And Bob Hunter, who is head of the NICO. I'm glad to see you made it. His was about the only voice that I could look to within the entire Federal Government that really was a spokesman for the consumer interests. I'm so pleased that he is now president of the National Insurance Consumer Organization because I feel that less is done on behalf of consumers from private consumer groups in the insurance industry than perhaps any other industry in the United States. We need you and your organization desperately.

So it should be a terrific presentation today.

Before we get there, I wonder if our distinguished ranking minority member, Mr. Shumway, has any comments he wants to make.

Mr. SHUMWAY. Thank you, Mr. Chairman. I do and I don't want to prolong the hour of hearings from our distinguished panel, but I do want to join you in welcoming our witnesses this morning, especially Mr. Schweiker, who has represented the State of Pennsylvania in his dual roles of Governor and Senator. I'm certain that his and the other witnesses' testimony will highlight to this subcommittee the ramifications of the Treasury tax simplification plan on the insurance industry and, more importantly, its customs.

The most important economic debate of this or any recent American administration is about to get serious. Tax reform has become the battle cry of every American and every Member of Congress. Indeed, the notions of simplicity, efficiency, and fairness are the *primary forces propelling this movement.* *As a result of this unprecedented* wave and momentum, the Treasury Department last year proposed a plan for tax reform. The Treasury proposal called for sweeping changes in our present Tax Code that would have a direct and immediate impact on almost every American business and individual, particularly the insurance industry and its customers.

Yet I believe we must look at this proposal regarding the changes to be made in this industry with an eye toward whether it addresses those basic goals—that is, simplicity, efficiency, and fairness that we all seek in reform.

The Treasury plan called for a major overhaul of the insurance industry's corporate tax structure and taxes on the products consumed, so to speak, by the majority of the American taxpayers.

In my opinion—and I am by no means an expert in this area—these changes meet none of these objectives. I note that the life insurance companies' corporate tax rules were substantially revised or modified, in fact simplified, by Congress just last year in the Deficit Reduction Act of 1984. At that time, Congress closely examined this issue to resolve the major problems and put the matter to rest.

Yet, less than 1 year later, when the changes of the 1984 changes have not yet been assessed, we are called upon to enact major and complex changes once again. I find this troublesome. It certainly does not simplify the tax system because companies will be forced to completely alter their existing operations. It does not promote efficiency within the insurance marketplace as companies cannot, absent any degree of certainty within the Tax Code, plan for the future. This seesaw approach is simply not fair.

More importantly, the Treasury's proposal countermands these goals, particularly with the changes planned for products sold to the American public. The plan to tax the inside buildup of individual life insurance policies, and the cash buildup on deferred annuities and other cash or deferred retirement plans would not simplify the system but, rather, would impose a new layer of unduly complex and burdensome requirements on these products.

Further, these changes amount to an unprecedented form of taxation on the American public which in my mind defies all sense of logic, reasonableness, and fairness.

In addition to these proposed changes, the Treasury plan calls for the taxation of employer provided group health and life insurance policies. While there may be some merit to this, that all individuals be accorded like treatment for like income including fringe benefits, I am concerned that we would shun incentives which produce a more economically efficient system.

I believe we should encourage the goal of privatization in our citizens, not only for health and life insurance coverage but also for adequate retirement plans. Otherwise, we risk imposing on our Government the role of primary welfare provider for Americans now and later.

Mr. Chairman, I believe in tax reform and I would like to see it accomplished. I also believe in the underlying objectives of simplicity, efficiency, and fairness. The Treasury proposal, however, is flawed in this respect.

I would also suggest that we not view this plan as an absolute, given the fact that a revised tax proposal—the so-called Treasury II—is about to be unveiled. Let us be mindful, though, that during this examination we consider the general question of reform with the main objectives at the top of the list.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you.

Mr. Dreier, would you like to make a statement?

Mr. Dreier. Thank you very much, Mr. Chairman.

I would like to applaud your decision to hold these hearings. I am sure the other members of this subcommittee will attest to the fact that taxation of insurance assets and taxation of employer provided benefits in general is the single most important constituent issue facing us these days. Over the Easter period I had the opportunity to talk to a number of insurance groups who raised several issues that I would like to pursue today and, of course, my office, like every other office on Capitol Hill, has been inundated with calls and letters from constituents who are apprehensive about the future of their employee benefits.

Let me simply say, Mr. Chairman, that I look forward to hearing from our witnesses. I am particularly interested in discussing the impact of the Treasury proposal on the average working family, which are the kinds of constituents I have been hearing from.

The second question is whether or not the Treasury proposals concerning life insurance would add to or decrease the complexity of the current system. I know that our discussion today is going to be fairly technical and I hesitate at the thought of how that discussion will translate into the Tax Code.

Thank you very much, Mr. Chairman.

Chairman LaFalce. Thank you.

Members of the panel, we have the prepared testimony of each of you. We will introduce it into the record in its entirety, and we would ask each of you to attempt to summarize your remarks in approximately 10 minutes. I would like to keep it to that so we can get into questioning and a good dialog of an hour or so. Mr. Schweiker, your 70-page statement is an outstanding definitive document on the issue but could not be read verbatim except only under the rules of the Senate, I suppose, where filibusters are permitted at any time and any place. Why don't we begin with you.

STATEMENT OF HON. RICHARD S. SCHWEIKER, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY LINDA JENCKES, VICE PRESIDENT OF THE HEALTH INSURANCE ASSOCIATION OF AMERICA [HIAA]; AND RICHARD MINCK, EXECUTIVE VICE PRESIDENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE [ACLI]

Mr. Schweiker. Thank you, Mr. Chairman. You may rest assured that I will leave my Senatorial instincts aside and remember my House training and exercise judicial restraint, and I have a very brief summary of that rather lengthy statement.

My name is Richard S. Schweiker. I am president of the American Council of Life Insurance, and am appearing this morning on behalf of the ACLI and the Health Insurance Association of America. I am accompanied today by Linda Jenckes, vice president of HIAA, and Richard Minck, executive vice president of ACLI.

The views contained in our statement have been endorsed by the Association of Advanced Life Underwriters and the National Association of Life Underwriters.

Mr. Chairman, we are grateful that you and the members of the subcommittee are holding hearings to look into the impact that the Treasury proposals would have on various industries and their customers.

We are gravely concerned about the consequences of proposed tax increases on individuals who purchase life insurance policies and annuities, and the consequences to employees and employers of proposed taxes on employee benefit plans, including pension plans.

The purpose of our appearance here today is to explain the reasons for our concern. The basic premise on which we base our comments is that the products we sell—life insurance, annuities and employee benefits such as group health and life insurance—presently provide essential financial protection and security to many millions of individuals. Most of these products also perform the extremely important function of facilitating the accumulation of capital which is so necessary to our economy.

In 1983, life insurers held over $655 billion in all forms of investments; and their purchases of all forms of long-term investment totaled $170 billion, including $39.4 billion in new funds for business capital formation. Life companies ranked fourth among domestic institutional sources of capital funds for the Nation's economy. In one key category, corporate bonds, the industry ranked first, ahead of all other providers of funds. We believe the administration's proposals, in their present form, run the risk of damaging those protections as well as our ability to provide capital to the American economy.

For almost half a century, Congress has encouraged American business and labor to create and maintain employee benefits programs for the security of the Nation's workers and their dependents. Similarly, Congress has encouraged individuals to purchase permanent life insurance and annuities to provide for their financial protection and retirement needs. A key element in the success of these private sector efforts has been the tax treatment provided by current law.

Let me explain our opposition to the Treasury's proposals. First, the proposal to tax the so-called "inside interest buildup" on permanent life insurance policies.

Permanent life insurance is not bought as an investment in competition with stocks, bonds, real estate or savings accounts. It is a product designed to spread the cost of life insurance protection evenly over the duration of the policy through the payment of level premiums. This feature makes permanent life insurance especially valuable to older Americans who wish to continue their protection at an affordable price. Since the policyholder is neither in actual or "constructive receipt" of the increasing cash values generated by level premiums until the policy is surrendered or terminated, he or she should not be taxed on such annual increases. To accept the Treasury proposal would be the same as taxing homeowners on the increased value in their home before they actually sold the property.

Taxing the inside interest buildup would hit older Americans especially hard, since the amount to be taxed under the Treasury proposal would be greater in retirement years. For some people, the taxes in some years would exceed the premiums paid in those years for the contracts.

Also hurt would be modest- or-middle income individuals, since as a group they are the largest owners of this product. In addition, the proposed tax would make the tax laws increasingly complex, it would upset millions of taxpayers, and it would not raise the revenue estimated by the Treasury. In fact, our estimates indicate some loss of revenues for the first 5 years and only a slight gain in the next 3 years.

Finally, let me point out that Congress completely overhauled the life insurance tax laws only last year under the Deficit Reduction Act. We do not believe there is any reason to change the law again 1 year later.

Many of the problems with the Treasury proposal for life insurance are also found in their proposal to tax annuities. For example, it would be a departure from the basic tax rules to expand dramatically the concept of "constructive receipt," as the Treasury proposes. Moreover, Congress examined the tax treatment of deferred annuities twice in the last 3 years, and we see no reason why that tax treatment should be examined or changed again.

Let me move on to the proposals to tax employee benefits. Despite the private sector's significant achievements in encouraging American workers to provide for their financial security, the Treasury's tax proposals would do away with the employee benefits tax incentive. A host of benefits, including health insurance, group term life insurance and 401(k) retirement savings plans, would be taxed, done away with or altered in some way. The question we ask is, why undo four decades of progress? Why risk the economic security of millions of Americans?

Placing a tax cap on health benefits, for example, could force the young and the healthy to opt out of the employee benefit plans they are in. This process would leave the older and less healthy members of the group to pay increases in the per capita costs. In addition, the Treasury proposal would discriminate against workers in areas where health care costs are high; it would discriminate against worker groups composed primarily of older workers whose health care costs are greater than those for younger workers; it would add complexity to the tax law, and it would not reduce overconsumption of health care. In our view, the ultimate impact of the tax on health benefits would be to badly damage private sector plans and place more of the burden of providing health care on the Government. In essence, to destroy the private sector safety net that we have built up over these years.

Many of the adverse consequences for group health insurance from the Treasury proposals would also apply to group term life insurance. By taxing the first $50,000 of this benefit, we would be discouraging workers from continuing their coverage and we would weaken employer-provided plans. The loss of needed coverage would lead inevitably to more demands on Social Security and other Government programs. The hardest hit by taxing group life insurance would be the moderate- or middle-income worker who depends on the group mechanism to provide him and his family with this protection. Amounts in excess of $50,000 are already taxed, so the higher paid workers would be proportionately less affected. It's worth noting that for many workers, group life is their only form of life insurance protection and among this group are many who cannot qualify for individual life protection because of physical problems or hazardous occupations who would have to make extraordinarily high premiums if taken out of the group concept.

Another benefit that would suffer under the Treasury's proposals is the popular 401(k) retirement savings plan. Although of recent origin, 401(k) plans have proven to be a very effective means of accumulating retirement savings for individuals and a new source of capital formation. In fact, a recent study found 401(k)'s to be a more potent tool to help individuals to save for their retirement than IRA's. These plans are designed to encourage a high rate of participation among all classes of employees. In this respect, they are among the most successful plans yet devised. 401(k) plans encourage today's workers to become tomorrow's well-prepared retirees, a sound retirement income policy by any definition. To the extent that the retirement needs of employees can be met by employer-sponsored qualified plans, it will not be necessary for the Government to provide additional aid to retirees.

Mr. Chairman, Congress has been wise for decades in legislating, through tax laws, encouragement to American business and labor to create and maintain financial security programs for our workers. As a result, the United States now has a partnership between Government and employer-sponsored programs that delivers income security to most workers against the major hazards of life. Our system, with its far-reaching and ever-increasing array of benefits—and its low cost to the public—is the envy of much of the world. To change the tax treatment of this system would be to do it serious, perhaps irreparable, harm. We believe the long-range welfare of millions of American workers and their families is far too important to damage for the goal of creating a broader tax base.

In conclusion, let me point out to the subcommittee an important fact that it should not overlook when assessing the impact of these proposals. The public is strongly against these proposals. An opinion poll conducted by Yankelovich, Skelly & Wright in March showed that while Americans are generally receptive to the idea of tax reform, they are overwhelmingly against the taxation of life insurance. Four out of five polled opposed the Treasury recommendation. In a Roper survey conducted in February, 77 percent of the public and 80 percent of chief executive officers polled said that workers should not be taxed on employee benefits. The feeling regarding employee benefits was so strong that one-quarter of those polled said they would rather have their income taxes raised than have their employee benefits taxed.

Finally, the Treasury proposals would increase taxes on life insurance companies by severely limiting the deductions life insurance companies could take for increases in reserves—liabilities—for their contracts. In addition, the Treasury proposals would eliminate the special deduction for life insurance companies and the provisions for small companies enacted by Congress last year as part of the complete revision of life insurance company taxation enacted as part of the Deficit Reduction Act. In each case, we object to the Treasury proposals and in my detailed statement I list some of the reasons why such proposals should not be enacted by Congress.

Mr. Chairman, we think it is clear that these proposals would have a negative impact on capital formation, job creation and the financial security of millions of Americans. We appreciate the opportunity to tell you where the life and health insurance industry stands and we place ourselves at your disposal to answer any questions or to provide you with any information you need in your investigation.

Thank you.

Chairman LaFalce. Thank you very, very much for an excellent statement, Senator.

[Mr. Schweiker's prepared statement, on behalf of both the American Council of Life Insurance and the Health Insurance Association of America follows:]

JOINT STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE HEALTH INSURANCE ASSOCIATION OF AMERICA

on

The Impact of the Treasury Department's Tax Simplification Plan on the Insurance Industry and Its Customers

Before the Subcommittee on Economic Stabilization
of the Committee on Banking, Finance and Urban Affairs
of the United States House of Representatives

May 8, 1985

Presented by

Richard S. Schweiker, President
American Council of Life Insurance

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

My name is Richard S. Schweiker. I am President of the American Council of Life Insurance ("ACLI") and I am appearing this morning on behalf of the ACLI and the Health Insurance Association of America ("HIAA"). I am accompanied today by Linda Jenckes, Vice President of HIAA and Richard Minck, Executive Vice President of ACLI.

The ACLI has 615 member life insurance companies who write about 95 percent of the life insurance written in the United States and hold 97 percent of the assets of insured pension plans. The HIAA has 350 member companies who write over 85 percent of the health insurance written in the United States by insurance companies. Many of the members of ACLI also write health insurance.

The Association of Advanced Life Underwriters and the National Association of Life Underwriters have also endorsed the views contained in this statement.

INTRODUCTION

Mr. Chairman, we are grateful that you and the members of this Subcommittee are holding hearings to look into the impact that the Treasury proposals would have on various industries and their customers.

We are gravely concerned about the consequences of proposed tax increases on (1) individuals who purchase life insurance policies and annuities; (2) employers and employees who sponsor and participate in employee benefit plans, including pension plans; and (3) life insurance companies. The current tax laws for life insurance companies and their customers were scrutinized very closely by Congress during the last four years and very extensive changes were enacted in 1984 as part of the Deficit Reduction Act of 1984. Other changes had been enacted two years earlier as part of the Tax Equity and Fiscal Responsibility Act. Now, within a few months of the passage of the most recent legislation, the Treasury Department proposes major changes in the treatment of policyholders and life insurance companies as part of their tax simplification plan. In many instances, these changes had been considered and rejected by Congress on previous occasions. These repeated proposals by the Treasury Department have had and are having an adverse impact on our markets because they cause customers to defer taking action because of tax uncertainties.

The Treasury estimates of the impact of these proposed changes add up to over $100 billion for the years 1986 through

1990. Nearly $80 billion would fall directly on our customers. These figures were included in Volume 1 of the Treasury Report.

The life insurance business is sympathetic with the broad objective of tax reform. We support the concept that all taxpayers should pay their fair share of the tax burden. However, we are very concerned about the scope and timeliness of the proposals in the Administration's tax reform program which would significantly affect policyholders and their beneficiaries, including large numbers of individuals who are purchasing individual life insurance and non-qualified annuities and many millions of employees covered by employer-financed life insurance, health insurance and pension plans.

The purpose of our appearance here today is to explain the reasons for our concern. The basic premise on which we base our comments is that the subject matter of the proposals -- individually purchased annuities, life insurance and other death benefit programs, health insurance, and pension plans -- presently provide essential financial protection and security to many millions of individuals. Pension plans, individual life insurance and individually purchased annuities also perform the extremely important function of facilitating the accumulations of capital, which is necessary for a dynamic economy, higher income levels and expanding employment. The provision, and expansion, of these inherently desirable forms of protection should be fostered and certainly should not be discouraged. However, as we will explain in detail, the Administration's proposals involve the serious risk of impairing the development of these essential protections. As the major industry which helps people to provide for their economic security, the life and health insurance industry is quite concerned by the adverse impact of these proposals.

For almost half a century, Congress has encouraged American business and labor to create and maintain employee benefit programs for the security of the nation's workers and their dependents. Similarly, Congress has also encouraged the purchase of individual life insurance and annuities. Support for these private sector efforts has been reflected in the tax treatment provided by current law.

To support its recommendations to make drastic changes in the current tax treatment of individual life insurance, annuities and employee benefits, Treasury argues that the tax laws could be simplified and tax rates reduced if these products were taxed. Of course, rate reductions could be made and laws simplified without changing the current tax treatment of individual insurance and employee benefits. The changes proposed by Treasury would completely reverse long-standing policies to encourage the growth of private retirement, health and life insurance protection. Such changes would ultimately lead to less private coverage and would undoubtedly result in a demand for increased federal expenditures to take up resultant slack in these areas.

Most taxpayers oppose changes in the tax system that would tend to undermine their economic security -- a view clearly confirmed by public opinion surveys we commissioned earlier this year. A survey conducted by the Roper Organization revealed that both the general public and chief executive officers of major corporations are overwhelmingly against taxing employee benefits. In fact, more people think we should consider raising income taxes than think we should consider taxing employee benefits. Another survey, by Yankelovich, Skelly and White, indicated that four-out-of-five Americans were opposed to the Treasury proposal to tax their life insurance.

The balance of our statement will detail each of the Treasury Department's proposals to increase the taxes on: (1) individual customers, (2) participants in employee benefit plans and, (3) insurance companies. It will also address the financial impact that these proposed changes would have on the insurance business and its customers.

SPECIFIC COMMENTS

I. PROPOSED TAX INCREASES ON INDIVIDUAL CUSTOMERS

The Treasury proposals would increase taxes on individual customers of life insurance companies in three areas. First, a new tax would be levied on what the Treasury Report calls the "inside interest buildup" on individual life insurance policies. Second, a corresponding tax is proposed for owners of individual annuity contracts. Finally, the Treasury Report proposes that amounts of money borrowed on individual life insurance policies be treated as taxable income. In each case, we will list some of the reasons why we object to the Treasury proposals.

A. PROPOSED TAXATION OF "INSIDE INTEREST BUILDUP" ON LIFE INSURANCE POLICIES

The Treasury Department proposes a new tax on life insurance policyholders based on the annual increase in the cash surrender value of a policy plus the annual "cost of renewable term insurance under the policy." They characterize these two items plus dividends less premiums as the "inside interest buildup" of a life insurance policy. At the same time, the Treasury proposal provides that a taxpayer may choose to designate the "inside interest buildup" for his life insurance policy as a contribution towards an Individual Retirement Account (IRA). The Treasury estimated that this proposed new tax would raise approximately $15 billion for the period 1986 through 1990.

For the reasons set forth below, the life insurance industry strongly opposes the proposed changes in the tax treatment of owners of life insurance policies. The proposal would change the tax treatment of life insurance afforded by the tax laws that have been in effect since income taxes were first enacted. It would treat owners of life insurance policies differently from other taxpayers who hold property that has increased in value but who have not realized that value. These drastic changes from the traditional tax treatment of life insurance are based on a faulty concept of life insurance and would have highly undesirable and inequitable social, economic and tax administrative effects. We strongly urge that the proposals to change the current tax treatment of life insurance be rejected and excluded from any tax legislation the Congress may consider.

Why the Proposal Should be Rejected

1. It is Based on a Faulty Concept of the Nature of Insurance

The values in a permanent life insurance policy are a by-product of the method of paying premiums for the insurance. The probability of death and hence, mortality costs, increase dramatically with advancing age. If premiums are set so as to follow closely current mortality costs, they would increase sharply as an individual insured grows older. However, permanent insurance is designed so that individuals may spread the cost of their life insurance evenly over the duration of their policies. Traditional level premium life insurance is a two hundred year example of such a design. The payment of level premiums, whether under traditional contracts or under newer designs, makes it feasible for older people to continue their life insurance protection.

The Treasury proposal states that the level premium mechanism results in liabilities (reserves) for insurance companies, and that the corresponding assets are the equivalent of separate savings funds for policyholders that are divisible from the rest of the life insurance contract. This is not so. The policy provisions, as uniformly interpreted by courts, make it clear that policyholders have no ownership interest in the assets balancing the reserves (liabilities) of the company and no ownership interest in the company's interest earnings on those assets. The Treasury's artificial separation of life insurance premiums into three components -- "pure insurance", "loading" and "savings" -- is an unsound analysis and would lead to artificial and arbitrary tax results.

A more accurate view of life insurance contracts is that they contain promises to pay benefits in certain events

-- usually death or the attainment of a specified age. The contracts also provide that upon termination by the insured, specified benefits may be available -- usually in the form of cash or paid-up insurance. Thus, cash values are obtainable, but this requires surrender of the contract in whole or in part. The premiums charged are for all the benefits provided by the contract, and such premiums are not divided into components. Individual buyers may not elect to have some benefits left out in exchange for a lower premium.

In offering their proposal, the Treasury has argued that taxation of the inside buildup would make the tax system "more neutral" with respect to present taxation of interest credited on bank deposits or paid to holders of bonds. The analogy to bank deposits and bond interest is flawed. Life insurance policies are distinctly different from bonds or bank deposits. Bank depositors and bondholders, in general, receive interest income from banks and bond issuers as a normal part of the transaction. Thus, they either receive specific amounts of interest in cash or have ready access to them in their accounts.

In contrast, life insurance policyholders do not currently receive, as cash, the amounts that would be taxed under the Treasury proposal as interest. In fact, the "cost of renewable term insurance" will exist only in a calculation to be required by the Treasury. As previously mentioned, policyholders can receive annual increases in the cash value of their policies by terminating or reducing insurance benefits. If a policyholder were to surrender his contract and then try to replace the insurance protection, he would encounter several problems. First, in order to qualify for new coverage, he would have to submit new evidence of insurability. Secondly, the new contract would have higher premium rates than the existing contract because it would be issued at a higher age than was the existing contract. Finally, other provisions in the new contract, such as settlement option guarantees, may be less favorable than the existing contract. These penalties obviously are different in kind from the reduction in interest on premature withdrawals of bank CDs.

The rise in the untaxed equity in an owner-occupied home is a more appropriate comparison with the "increased value" of life insurance policies. No one has seriously proposed that a homeowner should pay a tax on his rising equity before he sells his home. Moreover, he might have no source of funds to pay such a tax without selling his home. In similar fashion, the life insurance policyholder, faced with the proposed new tax. might have to surrender his policy and give up valuable rights to insurance protection, as described above. A related comparison is the appreciation in value of other assets, which is untaxed until the assets are actually sold. This approach of levying a tax only when income is realized from the disposal of an asset is the current tax treatment correctly given to life insurance policies.

2. It Would Change Fundamental Concepts of the Tax Law

The Treasury proposal for taxing the "inside interest buildup" is clearly inconsistent with historical and fundamental concepts of the tax law. Specifically, taxing the policyholder currently on increases in the cash surrender value or the "cost of renewable term insurance" would be contrary to a basic tax principle. The government should not tax individuals on amounts they cannot realize without giving up important rights and benefits. The question of "constructive receipt" has been tested before the courts, and the courts have held that there are substantial restrictions on the receipt of the cash value of a life insurance policy that precludes it from being taxed currently.

Again, a comparison to ownership of other assets is pertinent. A taxpayer could spend $100 on a share of stock and find that is has gone up in value to $300; it has a "cash surrender value" which has increased by $200. There is no section of the tax law which grants a "preference" to this $200 increase in value. It simply is not subject to an income tax until it is actually realized upon sale of the stock. To receive the $200 increase in value, the owner must give up a valuable right, namely, ownership of the stock.

In a practical sense, an increase in the surrender value of life insurance is even further removed from income than the unrealized appreciation in common stock. For a modest broker's fee, shares of the same stock can be easily acquired to replace those sold. But if a life insurance policy is surrendered, it may be impossible to replace it at an equivalent price if the policyholder either is older than he was when he purchased the surrendered policy or in poor health or both.

3. It Would Have an Adverse Impact on Older Americans

The Treasury proposal for taxing the "inside interest buildup" would place an increasingly heavy burden on policyholders as they get older because the amount to be taxed under the Treasury proposal is proportionately greater in later years. The tax on the income imputed under the Treasury proposal would, for many people, exceed the premiums for the contracts in their older years. Thus, the Treasury proposal would create a new tax, increasing by age, which would be particularly burdensome for the elderly.

As previously mentioned, the increasing values of a permanent life insurance policy are a by-product of the method of paying for life insurance by level premiums. It is sometimes suggested that the same life insurance benefit can be obtained by purchasing term insurance. This ignores the difference in the premium structures of permanent life insurance and annually renewable term insurance. With the former, the premium remains constant. With the latter, the premium increases with the age of the insured. With increasing age, the cost of term insurance for all but the wealthiest people becomes prohibitively high. Term insurance is not a satisfactory alternative to permanent life insurance, as a basis for providing coverage at advanced ages.

The dramatic increase with age in the cost of term insurance may be illustrated with reference to a typical premium for a $25,000 one year renewable term life insurance policy. At age 30, the premium is $85. By age 55, the premium has jumped to $384. At age 60, it is $558 and at age 65, it is $850.

An illustration of the additional imputed taxable income under the Treasury proposal is shown below for selected ages. The calculations are for a typical $40,000 whole life policy originally issued to a male, aged 35 for a $535 level annual premium. The imputed cost of insurance protection is based on the rates promulgated by the Internal Revenue Service to compute the "cost" of pure life insurance provided under pension and profit-sharing plans ("P.S. 58" rates).

Age	Increase in Cash Surrender Value for the Year	Imputed cost of Insurance Protection For the Year	Total Additional Taxable Income For the Year
55	$ 715	$ 383	$1,098
65	734	647	$1,381
75	638	1,006	1,644

Americans need insurance protection over their lifetimes. Continuing needs at older ages include provision for spouses and dependents who survive the breadwinner, as well as continuation of small businesses and family farms through purchase of the decedent's interest. Life insurance protection is also essential for Americans who are both marrying and starting families later. In all these situations, no other generally available product can provide the protection of permanent life insurance, and substantial tax increases at older ages would be especially harmful.

4. It Would Particularly Burden Modest and Middle Income Individuals

Level premium insurance is not a tax loophole or tax minimization device, but was developed to meet the need of policyholders for a practical and convenient means of continuing protection during their later years. Public attitude surveys clearly show that the great majority of people view the cost of life insurance as an expenditure or fee paid for protection against unexpected adversity.

The great majority of Americans buy insurance to protect those dependent on them in the event of their death. The enormous social good provided by permanent life insurance protection should not be ignored in considering whether a new tax is appropriate. In 1983, $7.0 billion was paid out in death benefits with 63% going to wives and children. Of the remaining amounts, portions went to preserving existing small businesses, family farms and other purposes. Two out of three death benefit payments were for less than $25,000. In 1983, 66% of the permanent life insurance policies were purchased on the lives of individuals with an income under $25,000 a year. These numbers clearly demonstrate that the benefits associated with life insurance go primarily to moderate- and middle-income families.

The Treasury Report includes a table showing the distribution of ownership of cash value life insurance by economic income. The table indicates that on the average, higher-income families have higher cash values in their life insurance than lower income families. Treasury refers to this table to buttress its argument that permanent life insurance is a vehicle used by the wealthy to shelter investments. This argument, however, is contrary to the evidence.

First, it is not surprising that wealthier families have higher cash values in their life insurance than families of lesser means. The wealthy, of course, own a greater percentage of all financial assets than persons of lesser means. Wealthier families are likely to have more assets, more expensive homes and larger home mortgages. The fact, however, that wealthier homeowners may have larger home mortgage interest deductions than poorer homeowners would hardly justify eliminating the deduction for home mortgage interest. Neither should this dubious rationale be used to justify eliminating the present tax treatment of life insurance.

Beyond this - and contrary to the impression the Treasury creates - wealthy taxpayers have little cash value life insurance relative to their other financial assets. The concentration in cash value life insurance among the wealthy is considerably less than their concentration in other financial assets. This conclusion is demonstrated by an "index of concentration" study, prepared by one of our member companies, wherein the holdings in selected financial assets of taxpayers with family adjusted gross incomes in excess of $100,000 were compared with the holdings in those assets of taxpayers with family adjusted gross incomes of $15,000 to $40,000. Under this analysis, an index value of one would mean that relative to income, ownership in a particular financial asset is equally concentrated at both the higher- and lower-bracket levels. An index of five would mean that the top income bracket owns five times as much in relation to their income as does the lower income bracket.

The results show a low index of concentration for the top bracket group in passbook savings accounts (.9) and a modest concentration for cash value life insurance (1.8). In contrast, the top bracket index of concentration moves up sharply for money market funds (3.2), mutual funds (4.2), publicly traded stock (16.2) and tax exempt bonds (40.8). Overwhelmingly, the concentration in financial assets of the top bracket group is in financial assets other than life insurance.

The greater variance in holdings between higher- and lower-bracket taxpayers is not in life insurance. It is in money market funds, mutual funds, other securities, publicly traded stocks and tax exempts. If life insurance were bought for its tax-favored income, those in high brackets would flock to it as they do to state and local bonds and other investments. They do not. Rather, investments like bonds and stocks are far more concentrated among the wealthy than is life insurance.

In contrast, the typical insured under a permanent life insurance policy is the head of a household having a total family income of less than $25,000 a year and has total life insurance protection equivalent to little more than twice his or her annual salary. This is clearly the portrait of a moderate- or middle-income individual who purchases permanent insurance to protect dependent family members from economic loss in the event of his or her death. It is not the portrait of a wealthy individual using life insurance as an investment tax shelter.

The Treasury argument that life insurance should be taxed as largely a tax shielded investment utilized by the wealthy is not substantiated by the facts. Rather than accomplishing equity, the Treasury proposal would simply impose a new burden on average Americans seeking financial security for their families.

5. It Would Upset Millions of Taxpayers

A dimension of any tax proposal, including the Treasury Department's base broadening proposal, is the matter of taxpayer perception. In order for a change to be widely accepted, it must be understood by the average taxpayer. We do not believe that policyholders will understand how and why they have additional income if the Treasury's proposal is adopted.

In theoretical terms, broadening of the tax base should include the imputed rent on owner occupied homes as taxable income. However, most citizens simply do not grasp the subtle arguments behind this concept in national income accounting. Therefore, only a few theoreticians would recommend taxing imputed rent as part of the base broadening concept. The increase in cash value of a life insurance contract presents the same situation. The idea that one earns "income" from life insurance surrender values and that such income should be taxed annually is a subtle concept that few people would view as logical or acceptable. It is even more subtle that this amount of income should be increased by the "cost of renewable term insurance".

One of the arguments given by the Treasury for its tax reform proposals in general is that taxpayer morale is undermined by the perception of tax loopholes enjoyed by others. While this may be true, morale is more adversely affected by taxpayers being told that their taxable income includes something they do not understand.

6. It Would Not Raise the Revenue Estimated By Treasury

In the Treasury Report, the revenue estimate for "repeal of exclusion of 'inside interest buildup'" is estimated as follows:

Fiscal Year	Revenue Gain to Treasury
1986	$1.3 billion
1987	4.0 billion
1988	3.6 billion
1989	2.8 billion
1990	2.9 billion

Our examination of these revenue estimates indicates that they seriously overestimate the revenue impact that the Treasury proposals would have. Instead, our estimates, based on the most reasonable interpretations and assumptions we can make, indicate that there would be a slight loss of Treasury revenues during the first five effective years of these proposals, only a modest revenue gain in the next three years, and a net gain of approximately $1 billion in the years 1995 and after.

There are several reasons why an increase in Treasury revenue cannot be expected to result from the Treasury proposals. During the first five years the proposed tax would apply only to newly issued policies, on which the calculated gain in policy values would be fairly small. The resulting tax would not reach the level of $1 billion per year until 1992 at the earliest. In the meantime, the election of the IRA option by some policyholders might reduce the Treasury revenues each year by an amount exceeding $1 billion in the early years and rising to perhaps $2 billion by the early 1990's.

The combined result of these proposed changes would, by our estimates, produce a slight revenue loss to the Treasury for the years to 1990 and only modest revenue gains in the years immediately following. Incidentally, our estimates include the impact of the Treasury proposal to tax policy loan proceeds -- otherwise we'd estimate the revenue losses at more than $1 billion per year for the first five years.

7. It Would Conflict With the Goal of Tax Simplification

Contrary to the announced goal of simplification, the Treasury's proposal for taxing the "inside interest buildup" would bring added complexity to the taxation of millions of policyholders. Annual calculations of the amount of additional income subject to tax would be required for millions of outstanding life insurance policies. The expense to insurance companies of computing and reporting the taxable amounts to individual taxpayers and to the Internal Revenue Service, and the expense to the IRS in administering the tax, would be substantial. Moreover, in many cases, the additional income imputed to the policy would be so small that the reporting expenses of the insurance companies and the IRS's cost of administration would approach or even exceed the taxable amounts. Further, millions of policyholders would be required to report as income small amounts that exist only in the calculations that would be required by the Treasury proposal. If a policyholder owns more than one policy, several income items would be involved. Policyholders would have no way to verify whether the amounts of income were correct since, unlike interest credited by banks, these amounts have no real separate existence of their own.

The Treasury proposal would allow individuals to use life insurance policies to fund Individual Retirement Accounts in order to reduce the impact of their proposed new tax. As discussed later, this would add to the complexity of the Treasury proposal. Further complexity would result upon the policyholder's death from the taxation of any amounts in a life insurance policy that were part of an IRA.

Significantly, a study 1/ was made in 1972 of whether the buildup in cash values under permanent life insurance should be measured and taxed annually to policyholders. The

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1/ Charles E. McLure, Jr., Economics of Federal Subsidy Programs, Joint Economic Committee, July 15, 1972, Part 3 Tax Subsidies.

study concluded that the administrative burdens and complexities which arise would outweigh any benefit of such a tax.

Confronted with this proposed new tax and the attendant complications of record-keeping, many people would doubtless be discouraged from the purchase of life insurance if the Treasury proposal were to be enacted. Some people might even consider these complexities as another reason, in addition to the cost of new taxes, to let their existing policies lapse. While it is difficult to estimate the net effect that the proposed new tax would have upon future sales and continuation of life insurance policies, the impact clearly would be to discourage rather than enhance the continuing purchase of life insurance protection. As a result, the future growth of financial security provided by life insurance for American families would be impeded, and the social value of such protection will be impaired.

8. It Would Impede Capital Formation

Taxing policyholders on increases in the value of their life insurance would make permanent life insurance more costly and less attractive. Reductions in sales of permanent life insurance stemming from this tax would impair private capital formation and economic growth. Life insurance companies have long been a major source of long-term investment capital. In 1983, life insurers held over $655 billion in all forms of investments and their acquisitions in all forms of long-term investment totalled $170 billion, including $39.4 billion in new funds for business capital formation. Life companies ranked fourth among domestic institutional sources of capital and financial markets, supplying 8% of all money flowing into such markets.

Adoption of the Treasury's tax proposal would reduce this important source of capital. By discouraging the purchase of permanent life insurance, the proposal would reduce a major source of funds available for investment.

The response that funds which, but for the tax proposal, would have been used to pay for permanent life insurance will simply become available to the economy through other financial intermediaries is not a convincing answer to the loss of capital flowing from life insurers. First, there is no evidence that funds diverted through permanent life insurance will be saved. Since people buy permanent life insurance primarily for protection, it is more likely that these sums will simply be spent rather than saved. Second, life insurance companies, because of the lifetime nature of the insurance protection they provide, are a source of long-term investment capital. Even if funds withheld from insurance companies were placed in other financial institutions, these institutions may have different investment practices and may not be a source of long-term investment capital.

Given the major concerns about a possible future shortage of capital funds, it makes no sense to limit the role of life insurance companies in providing the long-term investment capital that is essential for higher standards of living and the creation of new job opportunities.

9. The Use of IRAs Would Not Alleviate the Adverse Impact of the Tax

The Treasury has argued that the impact of taxing life insurance would be mitigated by its proposal allowing policyholders to designate increases in their life insurance values as contributions to an IRA. Specifically, policyholders could designate the "inside interest buildup" as contributions to an IRA.

The tax-favored status for individual retirement plans was intended as a way of encouraging individuals to make adequate provisions for their retirement security. The IRA provisions were structured so as to penalize individuals who sought to use IRAs for purposes other than savings for retirement. Currently, contributions to IRAs (up to $2,000 annually for an individual) are deductible and taxes are deferred on the earnings on these contributions. Both contributions and earnings are subject to tax as ordinary income when distributed. Individuals who withdraw their funds from an IRA before age 59 1/2 are not only taxed on the distribution but must pay a penalty. Individuals whose contributions to an IRA exceed the limits in any year are also subject to penalties. Individuals are barred from contributing to an IRA after the taxable year in which they reach the age of 70 1/2. Further, an IRA must begin making distributions by age 70 1/2.

All these rules surrounding IRAs were enacted to preclude their use for purposes other than savings for retirement. The fundamental purpose of permanent life insurance is not savings for retirement, but lifetime protection against the financial risks of death. This puts life insurance and IRAs at cross purposes. Forcing life insurance into the IRA mold when it does not fit would be poor tax policy and have harmful consequences.

Many policyholders would not be able to elect the IRA option for their life insurance because of the IRA limit on contributions. Some who could elect such an option now would experience a problem as they grow older. For many contracts, policy premiums less policyholder dividends and less "costs of renewable term insurance" will turn negative at ages well below retirement. This could be characterized as a premature withdrawal and subject to tax and penalty. In situations where the "inside interest buildup" is being treated as an IRA contribution, a dividend from the insurance company might throw the total contribution over the allowed limits. Thus, while the "inside interest buildup" might fit within IRA limits when a policyholder is young, it might not fit when the policyholder grew older and the "inside interest buildup" grew larger.

Individuals cannot contribute to an IRA beginning with the taxable year in which they reach 70 1/2 or beyond the point at which they stop working. Thus, a primary reason for permanent life insurance -- to provide an individual with fixed-cost lifetime protection -- would be undermined. By age 70 1/2 (or at retirement) individuals would be forced either to reduce the level of their life insurance or to cancel it entirely -- depending on the rules eventually promulgated by Treasury or the Internal Revenue Service.

Under an IRA program, if a distribution occurs prior to the time an individual reaches 59 1/2, there is a non-deductible 10% premature distribution penalty. Under current law, if an individual surrenders a life insurance contract, he appropriately pays tax on any gain generated by such surrender. Under the Treasury proposal, not only would there be a tax on all funds resulting from the surrender of a policy used to fund an IRA, but there would be imposed an additional 10% tax if the surrender occurred before age 59 1/2.

Under current law, gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured. There is no exclusion in the Internal Revenue Code for proceeds paid from an IRA upon the death of the participant. Thus, under the Treasury proposal, some of the proceeds paid under the life insurance contract by reason of the death of the insured would, for the first time, become taxable.

The Treasury proposal would introduce great complexity in determining and accounting for portions of policies considered within an IRA exemption and portions falling outside. The record-keeping requirements would produce substantial burdens, both for life insurance companies and for individual taxpayers.

Finally, the ultimate aim of the Treasury proposal is unclear. If most policyholders designate their "inside interest buildup" as contributions to IRAs, the Treasury proposal will not produce any additional tax revenues -

except to the extent that income taxes could be levied against part of the death proceeds. In combination, their proposed changes would not only be very disruptive to policyholders and to insurance companies, but would not raise the tax base -- in fact, the proposal might result in lower taxes for many years. On the other hand, if policyholders do not designate their "inside interest buildup" as IRAs, insurance costs would increase and life insurance protection would decrease. This result is both socially and economically undesirable. If the Treasury has concerns about level playing fields with other financial institutions they should be met by the current approach enacted by Congress in DEFRA. A definition of what constitutes "life insurance" separates contracts with "too substantial an investment element" from the more traditional types of life insurance contracts. Such investment oriented contracts receive tax treatment similar to the products of other financial institutions.

10. This Question Was Answered by Congress Last Year

The Treasury proposal ignores the major overhaul of life insurance taxation made by Congress only last year. In 1984 under DEFRA, Congress made a thorough study of life insurance contracts. It concluded that rules were needed to ensure that life insurance tax treatment at the company and policyholder levels was afforded only to contracts whose predominant purpose was the provision of life insurance protection. It established stringent statutory guidelines, endorsed by Treasury, which include a cash value accumulation test and, in the alternative, guideline premium and cash value corridor requirements. Contracts deemed "investment oriented" in the judgment of Congress now fall outside these guidelines and are not eligible for tax treatment as life insurance. Put simply, Treasury is now resurrecting a problem that was considered exhaustively by Congress last year and effectively resolved.

When Congress considered the matter recently, Treasury supported the basic tax treatment for life insurance policyholders. In 1983, John E. Chapoton, former Assistant Secretary of the Treasury for Tax Policy testified on this point before Congress. He stated:

> "(The Treasury Department) supports the continuation of properly structured incentives to encourage the purchase of life insurance....
>
> ...The treatment of (inside buildup bears) an important relationship to the definition of life insurance; that is, to the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the (inside buildup) under policies that fall under a tighter definition."

Congress tightened the definition in DEFRA. There is no good reason why the treatment of life insurance policies should now be changed again one year later.

Indications are that the Treasury proposal may be modified so existing life insurance policies would not be subject to the new tax on the "inside interest buildup." This would exempt existing policyholders from the complex calculations and incomprehensible additional tax, and therefore would encourage retention of insurance protection already put in place by these millions of policyholders. However, except to the extent grandfathering of existing policies provides deferral of the ultimate overall effect of the proposal, all the reasons given herein for rejecting the proposal remain valid. The undesirable and inequitable social, economic, and future tax administrative effects would still be inherent in the proposal, even if grandfathering were included. Taxing people on the increase in value of a contract they own when they cannot receive any cash income without giving up important rights and benefits, regardless of whether it is property they own now or property they will buy in the future, is wrong. Imposing an incomprehensible age-indexed tax on level premium life insurance so that people cannot afford to buy and keep lifetime protection is also wrong.

B. PROPOSED TAXATION OF "INSIDE BUILDUP" ON DEFERRED ANNUITIES

Under current law, an owner of a deferred annuity is not taxed on the increase in the cash value of his contract until he receives it. This has been the tax rule with respect to deferred annuities since the inception of the income tax. The Treasury proposes that the owner of a deferred annuity be taxed each year on the annual increase in the cash value of the annuity after taking into account any surrender charge or penalty. Thus, the owner would include in income for any year any increase in the amount by which the annuity's cash value exceeds the owner's investment in the contract. The Treasury estimates that its proposal will raise approximately $7 billion during the period 1986 through 1990.

For the following reasons, we are strongly opposed to any change in the current tax treatment of annuities. We believe the Treasury's proposal is inappropriate and harmful and would adversely affect policyholders who purchase annuities to provide for their retirement income.

Why the Proposal Should be Rejected

1. A deferred annuity is a unique vehicle for assuring financial security in retirement because unlike any other form of retirement savings, it guarantees a level stream of retirement income for life.

A deferred annuity contract is a unique vehicle for assuring financial security and independence after retirement. Unlike any other means of providing for retirement, deferred annuities provide protection against the possibility of outliving one's financial resources. Thus, the contract owner knows what his or her retirement income will be before reaching retirement and that his or her resources will not be exhausted prematurely. Variable annuities contain the same mortality guarantees but the income produced by the contract is not determined until the maturity date. Millions of Americans use either of these contracts as an important element in their planning for retirement.

Rather than encouraging individuals to make adequate provision for their retirement while they are working, the Treasury proposal would make deferred annuities more expensive and thus, create an incentive for the owners of these contracts to abandon them in favor of investment products which do not offer the same substantive guarantees as to income and duration. If Congress should adopt the Treasury proposal, people would be encouraged to direct their retirement savings to vehicles which would not provide the certainty and security which are the essential features of a deferred annuity.

To provide for financial security in their later years, Americans must combine formal retirement plans with personal savings. Pension plans and individually purchased annuities also perform the extremely important function of facilitating the accumulation of capital, which is necessary for a dynamic economy, higher income levels and expanding employment. The provision, and expansion, of these inherently desirable forms of protection should be fostered and certainly should not be discouraged. By discouraging the purchase of deferred annuities, the Treasury proposal would deter Americans from using a particularly effective and important means of accumulating personal savings to assure a reasonable quality of life after retirement.

2. Adoption of the Treasury Proposal would mean a departure from the basic tax rule that an individual should not be taxed on amounts the receipt of which is subject to substantial restrictions. An annuity owner cannot obtain the amounts which would be taxed without giving up valuable rights and guarantees.

The Treasury proposal would tax owners of annuities each year on increases in the value of their contracts although they have not received these amounts and their rights to receive these amounts are subject to substantial restrictions. Thus, taxing annuity owners on the "inside interest buildup" would be contrary to the long-standing tax law rule that income, the receipt of which is subject to substantial restrictions, is not constructively received.

An annuitant can generally obtain the cash value of the contract only by surrendering the annuity and losing the important financial guarantees which it provides. To replace these guarantees, the annuitant would have to apply for a new deferred annuity contract, pay new acquisition costs and a higher premium rate.

3. Current law does not allow deferred annuities to escape tax; it only permits a deferral of tax.

The present rules for the taxation of annuities provide an equitable means of taxing these contracts. These rules do not involve forgiveness of tax. Instead, they provide for a deferral of tax.

The annuitant is treated as being in receipt of annuity income when annuity payments commence. When these payments commence, each payment is considered to consist of a ratable portion of the owner's investment in the contract and of interest income. Under this rule, if an annuitant dies early, few payments are received and little tax is paid; however, any payments to a surviving beneficiary are also subject to tax. On the other hand, if the annuitant lives for a longer period than expected, more payments are received and more taxes are paid. In contrast to the treatment provided under current law, the Treasury proposal would levy taxes on increases in cash values, even though the contractholder might never actually receive such monies. In sum, deferred annuities are purchased out of after tax income and current law provides that a tax be paid on interest income only when such income is actually received.

4. Congress examined the tax treatment of deferred annuities twice in the last three years. It added penalties under the tax law on premature withdrawals to assure that deferred annuities are used to provide long-term retirement protection and not as short-term investment vehicles.

The issue of how individual deferred annuities should be taxed was extensively considered by Congress under TEFRA in 1982 and again under DEFRA in 1984. Congress addressed the concern that deferred annuities might be used to shield short-term investments from tax. It solved this problem by enacting strict rules which penalize annuity owners for premature withdrawals of funds. These penalties are meant to assure that deferred annuities are used as long-term retirement vehicles. With these changes, it was concluded that "the use of deferred annuity contracts to meet long-term investment and retirement goals was still a worthy ideal". (Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961, 97th Congress, Public

Law 97-248, p. 361)). In sum, the fundamental objection to deferred annuities raised by Treasury -- that they can be used to shelter short-term investments -- has already been twice addressed by Congress and has already been met.

C. TREASURY PROPOSAL TO TAX POLICYHOLDER LOANS

A level premium policy must accumulate cash value in order to assure that the cost of insurance will be met in later years. A policyholder, like the owner of any other assets having an ascertainable value, may use the policy as security for a loan. Under current law, the owner of a life insurance policy does not receive taxable income when a loan is made using the policy as security for the loan. The policy loan accrues interest and must be repaid on or before the policyholder's death. These basics are true whether the lender is the issuing insurance company or a third-party lender. The interest paid on a policy loan, like interest paid on any other loan, is generally deductible.

The Treasury proposes to treat policyholder loans as a distribution of taxable income to the policyholder to the extent the policy's cash value at the time of the loan exceeds the policyholder's cost basis. In addition, under another provision of the proposal, the deduction for interest paid on all indebtedness, including policy loans, would be limited to $5,000 in excess of a taxpayer's net investment income. The Treasury does not assign a revenue estimate to their proposal on policyholder loans.

Why the Treasury Proposal Should be Rejected

1. Policy loans should not be treated differently for tax purposes than loans secured by any other asset.

A fundamental tax principle, which has long been recognized, is that gain must be realized before it is subject to tax. It is also recognized that an asset must be disposed of before any gain resulting from ownership of the asset is realized.

Courts have long held that merely obtaining a loan secured by an asset is in no way equivalent to the disposition of the asset and therefore the realization of income. Interest accrues on policy loans and they must be repaid on or before the date on which the policy matures. The death benefit payable under a policy is reduced by the amount of any loan outstanding at the time of the death of the policyholder. Of course, the policyholder is free to repay a loan at any time in order to maintain a death benefit equivalent to the policy's face amount.

Since it is recognized that a loan is not a disposition of the asset securing the loan, there is no justification under sound tax principles for the Treasury's proposal that policyholders be taxed on life insurance loans which they make. Indeed, the Treasury's proposal does not provide that a loan secured by any other asset will be treated for tax purposes as the disposition of that asset. Thus, the Treasury's proposal is not only unfair but also totally inconsistent with the well-established tax principle that the tax laws should be applied uniformly to all taxpayers.

2. The proposal is contrary to fundamental tax principles which recognize that a taxpayer may recover cost before receipt of any taxable gain.

Under current law, sums withdrawn from a life policy are treated as first coming from the policyholder's cost basis. This is nothing more than recognition of the general principle that a taxpayer should be permitted to recover his or her basis in an asset before being subject to tax. The Treasury proposal, which would treat sums withdrawn from a life policy as first coming from any gain resulting from ownership of the policy, does not offer a cogent rationale for reversing this tax rule.

3. The burden of the proposal would fall on moderate and middle-income individuals.

The majority of insureds owning permanent life policies reside in households having a total family income of less than $25,000 per year. These are the persons who would be most affected by a change in the treatment of policy loans.

For many, their permanent life insurance policy may be their major source of credit.

Treasury suggests that policy loans are designed and utilized to provide substantial tax advantages to policyholders. In fact, most policy loans are used to meet family expenses or to keep the policy in force. Taxing policy loans will not necessarily reduce or eliminate these needs for credit. To the contrary, the proposal may well increase the size of policy loans since policyholders will have to borrow an amount sufficient to pay the accompanying tax. In the case of many policies with automatic premium loan provisions, the premium loan may produce a significant tax liability which may result in the surrender of policies.

The ultimate results of taxing those who must borrow on their permanent life insurance in order to meet living expenses or to maintain the policy in force is a reduction in the amount of insurance coverage which will be more acute in the case of lower income groups. Rather than eliminating a perceived "loophole", the Treasury's proposed new tax will tend to hurt average Americans and their families.

4. Only last year, Congress considered whether changes should be made in the tax law covering policy loans and decided that the provisions of existing law were appropriate.

In 1983 and 1984, Congress thoroughly examined the taxation of life insurance companies, their products and policyholders. Among the areas Congress studied was the taxation of policyholder loans. It decided that the provisions in existing law did not require amendment. There is no reason to consider this matter again.

5. Policy loan interest should be deductible without limitation because policy loans make it possible for policyholders to meet financial needs without surrendering their insurance protection.

The Treasury proposal would limit the deductibility of interest paid or incurred on indebtedness to $5,000 plus the amount of the taxpayer's net investment income. There are sound reasons for not subjecting interest on policy loans to this limitation.

The policy loan feature of life insurance makes it possible for the policyholder to use policy loans for matters such as financial emergencies or education of children without the necessity of surrendering the policy in order to obtain its cash value. The result is that the death protection provided for the policyholder under the policy remains intact for the benefit of the insured's dependents. Congress should continue to encourage policyholders to keep their death benefits in force rather than encourage surrender of insurance in order to obtain cash values to meet immediate financial needs.

II. PROPOSED TAX INCREASES ON PARTICIPANTS IN EMPLOYEE BENEFIT PLANS

For almost half a century, Congress has encouraged American business and labor to create and maintain employee benefit programs for the security of the nation's workers and their dependents. A key element in providing support for these private sector efforts has been the tax treatment afforded certain benefits under current law.

This tax treatment has produced impressive results at minimum cost to the government.

- Employee benefits are available everywhere.

A 1983 U. S. Chamber survey revealed that 99 percent of the firms surveyed offered group health and life insurance, 83 percent offered a pension, and 65 percent had education assistance programs. One hundred and sixty-two million American workers and their dependents are protected by an estimated one-half million employee benefit plans. A 1983 U. S. Department of Labor survey found that 96 percent of all workers in medium and large sized firms were covered by group life insurance. A similar percentage were covered under group health insurance plans, while 82 percent of the workers in these firms were covered by a pension plan.

- Employee benefits help low- and middle-income families most.

Seventy-five percent of employees covered by employer-sponosred life health and pension plans earn less than $25,000 per year. Seventy-four percent of the employer monies placed in pension funds are targeted for individuals with incomes less than $50,000. Pension and group life and health insurance coverages are widely distributed among all income groups.

These very significant achievements in providing financial protection for American workers would be endangered by Treasury proposals in a number of areas. Three of these proposals deal with areas in which benefits are often provided by life insurance company contracts -- namely:

A. Health insurance premiums (over $70 per month for individuals and $175 for family coverage) paid by the employer would be taxable to the employee;

B. Employer costs for the first $50,000 of all group life insurance would be taxable to the employees; and

C. The popular 401(k) retirement savings program would be eliminated;

In each case, we will list some reasons why we object to the Treasury proposals.

A. PROPOSED TAXATION OF EMPLOYEE HEALTH CARE BENEFITS

Employer-provided health care benefits are of enormous value to the public. The health insurance provided under employee benefit plans provides reimbursement for hospital, physician, dental and other medical expenses. We estimate that at the end of 1982, almost 65 million workers had group health coverage. Including spouses and children, approximately 162 million persons under age 65 were covered by one or more forms of private group health protection. That represents 80% of the under 65 civilian population, and is a five fold increase since the end of World War II.

Under current law, employers are allowed to deduct contributions made to an employee health benefit plan, and employees are not required to include these amounts in their taxable incomes. Treasury proposes to limit the amount an employer may contribute to an employee health care benefit plan without creating taxable income for employees. The limit is $70 per month for an individual and $175 per month for a family. Contributions by an employer in excess of these limits would be taxable to the employee. Treasury recognizes there is a national policy to promote health care services. It urges, however, that the caps are necessary to reduce "overconsumption" and to produce more revenue. The estimated increase in revenue is $34.3 billion for the period 1986 through 1990.

Why the Proposal Should be Rejected

1. The burden of the tax cap would fall unequally on workers depending upon where they work, their ages and their occupations.

The cap would discriminate against workers in areas where health care costs are relatively high -- such as California and New York -- where employers must pay twice as much or more for health care coverage as is paid in areas of relatively low health care costs -- such as North Dakota. A recent HIAA study compared the impact of the proposed cap in various cities on the same comprehensive health plan. The increase in taxable income for workers covered by the plan (500 life group family coverage) was $1,946 in Los Angeles, $1,393 in New York City, $305 in Jackson, Mississippi and $135 in Fargo, North Dakota.

The tax would also discriminate against worker groups composed primarily of older workers whose health care costs are greater than those for younger workers. The average age of workers from industry to industry throughout the United States varies considerably. Plans covering workers with a higher average age are more costly and these workers would be subjected to higher taxes under the proposal

Finally, the tax would fall disproportionately upon workers employed by small businesses and workers employed in high risk or hazardous occupations. Small businesses typically pay more for health care coverage because of higher administrative costs and greater variability of claim costs. High risk workers' costs are, obviously, higher because of the greater risks and higher resulting claims.

2. Imposing a tax on group health benefits could result in adverse selection as the young and healthy opt out of the plan, leaving older and less healthy members in the group to pay the cost of the plan. The resulting degeneration of plans would move the burden of providing health care to the government.

Current tax laws have long been recognized as playing a key role in the development of the privately financed benefits system. If the group insurance mechanism is to operate effectively, essentially all employees in a group must be covered. This is currently achieved by having the employer pay much of the premium, with employees paying no tax on the employer's contribution. If the cost to employees is increased by having some or all of the employer's contribution added to their taxable income, some employees may have to drop out. The first to leave the plan will be the young and healthy (who are at relatively low risk) workers who need the money. As a result, premium costs will rise for the older and less healthy employees who retain coverage. The spiral of higher premiums, higher taxes and progressively fewer covered employees will have begun. The degeneration of plans will ultimately follow. It will be the lowest-income worker who will be hit first and hardest.

3. The tax cap would place essential preventive care in jeopardy as employers who want to avoid additional reporting requirements and employees who do not want additional taxable income will move towards limiting contributions to the amount which is not taxed.

To avoid exceeding the proposed cap, employer contributions would concentrate on purchases for hospital coverage, and preventive protection is likely to be reduced. Dental and vision care, mental health benefits and alcohol and drug abuse services may be dropped from health care benefit plans in order to keep the employer's contribution below the cap. These are sound and needed programs and the resulting reductions in coverage will adversely affect them.

4. The tax cap adds more complexity, not simplicity to the tax law. The complexity arises from the processes and difficulties involved in computing the per employee costs around the country, reporting costs to employees, including the cost in the employees' tax return and auditing all of the above.

If the tax cap is adopted, employers will have additional costs because of the requirement that they report the taxable amount for each participant in the plan. Isolating health care costs around the country which are subject to the computation will require a major effort. Building systems that will do this work will be complicated and costly.

5. The tax cap would not reduce overconsumption of health care.

The Treasury asserts that the tax cap would be a significant tool to "reduce overconsumption of health care services". If there is "overconsumption" this is not the way to address it. Assuredly, there has been inflation in health care costs. The cost of health care is a problem for employers and employees regardless of whether a tax cap is imposed. It is a problem not just for private insurance programs, but for Medicare, Medicaid and people who have no insurance at all. Many employers are already making changes to alleviate the cost of the health care plans they now provide. This is going on without any changes in the tax system.

Traditional insurance plans are being modified to increase deductibles and coinsurance requirements so that individual employees have a greater interest in controlling their use of health care facilities. In addition, preadmission testing and second opinions before surgery are offered or required to reduce hospital stays and eliminate unnecessary surgery. Health care systems are changing with the growth of fixed fee Health Maintenance Organizations, which emphasize preventive health care and Preferred Provider Organizations, which offer guaranteed rates in exchange for guaranteed volumes of business. Hospital costs have been the major factor in health care inflation but this problem is being addressed directly by employers, insureds and hospitals. The government itself increasingly regulates health care growth and spending by hospital cost control programs, capital planning and mandatory utilization review.

The net result has been to reduce significantly excessive health care cost inflation. For the twelve months ending September 1984, health care cost inflation was 1.5 times the CPI, down from 1.7 times in the twelve months ending December 1983 and 2.8 times in the twelve months ending December 1982. The problem of inflation in health care costs should be addressed and is being addressed through changes in the way the health care system works, not through an additional tax on workers.

B. PROPOSED TAXATION OF THE FIRST $50,000 OF EMPLOYEE GROUP LIFE INSURANCE

Group life insurance has been increasingly popular since its introduction in 1911. At the end of 1983, group life insurance in force through employers was $1.7 trillion and more than one-half million employers of all sizes had purchased life insurance for their employees. In a 1983 survey conducted among medium and large employers by the U.S. Department of Labor, 96 percent of all employees of these firms were reported to be covered by group life insurance.

In recent years, the attractiveness of group life insurance has led an increasing number of employers to extend such insurance beyond the working years of their employees. In a survey conducted by The Conference Board in 1979, more than two-thirds of a sample of large and small employers indicated that they were continuing some group life insurance protection into retirement. A later survey conducted in 1983 by Hewitt Associates indicated that among large employers the percentage exceeded 80 percent.

As shown by these statistics, employer-provided group life insurance has grown rapidly in the 73 years since it first became available. There are broad social aspects to the growth of group life insurance. One great service of group insurance is that it extends life insurance coverage to a large number of persons with little or no other life insurance. And, group life insurance also extends protection to persons who cannot qualify for individual life insurance either because of physical problems or hazardous occupations. The proportion of employed persons who are uninsurable for individual policies has been variously estimated between 5 and 10 percent. It is only through group underwriting that private life insurance can provide protection for these persons, and it is advantageous both to the individual and to society that insurance be made available to them.

Under current law, employers are allowed to deduct premiums paid for group-term life insurance provided to employees. Employees may exclude from their income the cost of the first $50,000 of employer-provided group-term life insurance.

Treasury would repeal the exclusion related to the first $50,000 of coverage. Treasury asserts that this is warranted because the exclusion produces inequities between taxpayers, favors taxpayers in high brackets and encourages overconsumption of life insurance. The Treasury revenue estimate for additional taxes under this proposal is $10 billion for the period 1986 through 1990.

Why the Proposal Should be Rejected

1. Congress has repeatedly reaffirmed its policy to encourage group life insurance as an employee benefit.

In 1982 under the Tax Equity and Fiscal Responsibility Act ("TEFRA") and again in 1984 under the Deficit Reduction Act ("DEFRA"), Congress examined the group-term life insurance exclusion. Antidiscrimination rules were added in 1982. In 1984, these rules were made applicable to retirees who also became subject to the $50,000 limitation. In making these changes while leaving the $50,000 exclusion intact, Congress reaffirmed that the $50,000 exclusion made sense and should be preserved.

2. Group-term life insurance is a nondiscriminatory method of providing life insurance protection. It is available to employees under rules which assure that there is no preference for higher paid employees.

A reason suggested for taxing employee benefits has been that in some cases they are available only to higher salaried or key employees. This is not the case with group-term life insurance. Congress covered this point in TEFRA. As the number of employer-sponsored group-term life insurance plans increased, there was concern that the tax incentives available under these plans could be used to discriminate in favor of highly compensated employees. As a result of the changes made in TEFRA, the $50,000 exclusion is not available to key employees who are unfairly benefited by a plan with respect to eligibility, benefit type, or benefit amount. Additional nondiscrimination provisions were enacted by Congress in 1984 in DEFRA, so that the concern regarding possible abuse of the tax incentives provided for group-term life insurance has already been met by Congress.

3. Group life insurance is not "overconsumed". The average amount of employer-provided group-term life insurance per employee is approximately $26,000. This modest amount of coverage is equivalent to continuing the average worker's salary for less than two years. This is not a "windfall" -- but rather a modicum of financial assistance -- to the worker's spouse and children.

There is no overconsumption of group life insurance. Currently, an estimated 90% of covered employees receive less than $50,000 of group life coverage. The average amount of employer- provided group life insurance per employee is about $26,000. It is hard to imagine that this modest coverage -- equivalent to continuing an average worker's salary for less than two years -- will replace a worker's lifetime income much less provide a windfall to a surviving spouse or child.

4. Group life insurance affords needed protection for workers who cannot medically qualify for individual life insurance and for many workers who have no other form of individual life insurance.

For many workers, group life insurance is their only form of life insurance protection. Among these are persons who cannot qualify for individual life insurance either because of physical problems or hazardous occupations. It is only through group underwriting that private insurance can provide protection for these persons. Beyond this, group life insurance is attractive because of its low cost. Without it many workers would have no protection.

5. The new tax would discourage workers from continuing their group life insurance coverage and weaken employer-provided plans. The loss of needed coverage would lead to more demands on Social Security and other government programs to provide the benefits.

If employees must pay taxes to maintain their group life insurance, many looking to short-term cash needs may terminate their insurance. Terminations by younger and healthy workers will increase costs for remaining workers. This will begin a weakening of employer plans so carefully put together by labor and management. Ultimately if insurance is not available upon an employee's death, non-working survivors will require care and support from other sources -- most likely increased Social Security or other government programs. In all likelihood, the long-term costs of the benefits the government will be called upon to provide will far offset the revenue the Treasury might gain from elimination of this modest exclusion.

6. The rationale which persuaded Treasury to leave the fundamental tax rules for qualified pension plans intact should apply to employer-provided group life insurance.

The Treasury has appropriately agreed that the basic tax treatment afforded qualified pension plans should not be disturbed. These plans -- which are subject to anti-discrimination requirements -- provide protection for employees and their families in later years. It has been said that they afford financial protection if the employee "lives very long". The same considerations should apply in the case of employer-provided group life insurance. This coverage -- which is also subject to anti-discrimination rules -- provides protection for an employee's family if the employee "dies too soon". There is room in sound tax policy for retaining the present encouragement for workers to protect their families in either event.

C. PROPOSAL TO ABOLISH SECTION 401(k) PLANS

Section 401(k) plans, also called "CODA's" (cash-or-deferred arrangements) were first permitted by the Revenue Act of 1978. Since 1982, these plans have rapidly become an important element in retirement savings and are, perhaps, the most popular benefit available judging from the number of plans being implemented.

401(k) plans are employer-sponsored programs that permit employees to defer current compensation to meet future financial needs. Amounts contributed to the plan are not includible in the employee's gross income at the time of contribution provided specific requirements are met.

The Treasury has proposed that the tax provisions authorizing Section 401(k) plans be repealed with respect to contributions to the plan on or after January 1, 1986. The revenue estimate is $4.6 billion over five years.

Why the Proposal Should be Rejected

1. Section 401(k) plans provide employees with an attractive savings alternative for retirement.

In proposing to increase the limits on contributions to IRA's and to eliminate 401(k) plans, Treasury is selecting

IRA's as the appropriate vehicle for the receipt of deductible retirement plan contributions by individuals to the exclusion of their existing plans. This would be a serious mistake and short sighted tax policy. The use of effective group arrangements, such as Section 401(k) plans, for the provision of retirement benefits should also be encouraged and should coexist with IRA's.

While Section 401(k) plans have favorable characteristics and attributes not shared by IRA's. A 1983 study by Hewitt Associates found such plans to be a more potent tool for individual retirement savings than IRA's. That study's results demonstrated that only 16.9 percent of the work force had established IRA's and that usage was highest among the higher paid employees. Only 11 percent of workers earning less than $20,000 established IRA's compared with 58 percent of those earning more than $50,000. In contrast, among some 250 corporate 401(k) plans surveyed, the average employee participation rate was 81 percent.

Recently tabulated Census Bureau data indicates that low-income workers, earning between $5,000 and $10,000, were three times more likely to participate in a 401(k) plan than in an IRA. Middle-income workers, earning up to $29,999, preferred 401(k) plans over IRA's two to one.

2. Section 401(k) plans distribute pension benefits across income classes and must meet very strict non-discrimination requirements. These plans are subject to audit to assure that all requirements are observed.

401(k) plans must satisfy special and rigorous non-discriminatory requirements. The special 401(k) rules prohibit discrimination in favor of "highly compensated employees" with regard to deferred amounts. Highly compensated employees may not contribute more than an allowable percentage of their compensation to a 401(k) plan. This percentage is directly influenced by the extent of participation in the plan by rank and file employees. These plans are, unlike IRA's, subject to audit to assure that all requirements are observed. It is, therefore, in the interest of the highly compensated employees for the employer to encourage and sustain broad and meaningful plan participation on the part of rank and file employees.

The amounts involved under Section 401(k) plans do not escape tax. Taxes are simply deferred until the employee retires and receives the income. The Employee Benefit Research Institute has found that 72% of the tax deferred by active employees is eventually repaid in retirement.

Employer-sponsored plans are a sound and cost effective way to provide for retirement. For example, the "Final Report by the President's Commission on Pension Policy," 1981, recognized that "a major objective of retirement income policy should be to insure that today's retirees and tomorrow's elderly are able to maintain a reasonable standard of living in their later years." In view of this, the President's Commission recommended the expansion of the role of employer-provided deferred compensation plans.

To the extent the retirement needs of employees can be met by employer-sponsored qualified plans, it will not be necessary for the government to provide additional aid to retirees.

Employer-sponsored retirement plans encourage capital formation. Private savings and capital formation should be encouraged. One way this goal can be achieved more effectively by Congress is through encouragement of broad-based retirement plans maintained by employers to provide income security for great numbers of employees. Capital formation achieved through employer-sponsored plans will benefit the economy while at the same time employees will obtain the benefit of participation in employee benefit plans such as Section 401(k) plans.

III. PROPOSED TAX INCREASES ON LIFE INSURANCE COMPANIES

The Treasury proposals would increases taxes on life insurance companies in three areas. First, the Treasury would limit the deductions companies could take for increase in reserves (liabilities) to increases in cash values -- even for contracts that have no cash values. Second, the Treasury would eliminate the special deduction for life insurance companies, enacted last year as part of the revisions of the life insurance company tax act. Finally, the Treasury would repeal the provisions for small companies enacted as part of the same law. These tax increases would be offset by a reduction in rates. In each case, we will list some reasons that we object to the Treasury proposals.

A. PROPOSED MODIFICATION OF THE LIFE INSURANCE COMPANY RESERVE DEDUCTION

Under current law, life insurance companies are allowed deductions for increases in life insurance reserves. Treasury proposes to limit reserve deductions to the increase in the amount of cash values of policies. The effect of this proposal is to reduce early year reserve deductions for ordinary life insurance and some annuities, and to deny any reserve deduction for most policies of term and group insurance and for many supplemental benefits which do not have any cash value. The Treasury estimates a revenue increase of approximately $3.5 billion for the period 1986 through 1990.

Why the Treasury Proposal Should be Rejected

1. The proposal is based on the mistaken view that life insurance companies are over-reserved.

DEFRA adopted the accounting rule that a deduction could not be taken before there was "economic performance". (Section 461(h) of the Internal Revenue Code). The Treasury proposal, based on the mistaken view that life insurance companies are over-reserved, applies this rule to life insurance company reserves. The effect of the proposal is to deny life insurance companies any reserve deductions; deductions would be allowed only when the insurance is paid.

The premise of over-reserving is wrong. In 1984, Congress substantially revised the tax rules governing reserve of life insurance companies. The new rules are far more stringent than the prior ones and require that to be recognized for tax purposes, reserves must conform to the minimum liabilities required by the laws of at least 26 states or to the cash surrender values of each contract, if greater. This Congressional decision was reached after discussion among Committee staff and the staff of the Treasury.

The 1984 Congressional actions were taken in recognition that in the past few years the states have moved effectively to require reserve assumptions consistent with contemporary conditions. Most significant in this update was the adoption by the states of dynamic valuation laws which now automatically adjust reserve interest assumptions annually to market conditions.

As a result of their concern about over-reserving, the Treasury proposal would delay deductions for life insurance companies until losses were actually paid. For an insurance company, however, an ordinary and necessary expenditure occurs when the insurance company takes on an obligation and establishes a reserve. It is simply illegal to do insurance business without this reserve. This is the true measure of the economic income of the insurance company. An insurance company achieves economic performance when it establishes the reserve. Substituting, cash values would be inappropriate as a measure of the liabilities of life insurance companies. As Professor Dan McGill of Wharton states in his textbook Life Insurance, p. 299 "While both of these values (reserves and cash values) arise out of the leveling of premiums, they have no other connection and serve quite different purposes."

Congress enacted the economic performance test as a means to deal with major misstatements of income. Within the new accounting rule itself, there are various exceptions including: (a) items specifically covered by reserve provisions elsewhere in the Code; (b) amounts covered by the all events test which will be paid after 8 1/2 months after the close of the year; and (c) recurring items where accrual of such items are more properly matched with the earlier year's income. For many of the coverages which would be affected by the Treasury proposal, either there is no major misstatement of income or one or more of the exceptions would apply. In short, there is no reason to adopt the Treasury proposal.

Since passage of the 1984 Act, the life insurance companies have invested enormous amounts of manpower and computer time to implement the new reserve rules. The disruption involved in changing accounting systems to reflect small changes in the timing of income is unrealistic. This result is in sharp contrast to the tolerance that would be allowed to banks in the timing of deductions under the Treasury program. For example, a bank could deduct the full deposit and accrued interest on a six-month CD purchased three months before the end of the year even though it would impose a large surrender charge on a withdrawal at the end of the year.

The Treasury proposal to change life insurance reserve treatment is severe and not well thought out in detail. It is particularly inappropriate for annuities in payment and it is extremely harsh on a company going into a new line of business. Annuities in payment do not have cash values, but clearly companies have liabilities under such contracts. Moreover, the individuals are currently taxable on the interest component of each annuity payment and it would constitute double taxation to tax the life insurance company on the same income.

2. The proposal will have a significant adverse impact on the life insurance business.

As proposed, the Treasury change would impose a charge on life insurance companies that could more than double the amount payable in the first year under current tax law. Even after the transition period, the annual cost could approach $1.5 billion, which is twice as high as the figure shown in the Treasury report. This has some significant consequences for life insurance ocmpanies in the short run.

The proposal will also make it more expensive for insurance companies to reserve for future commitments. The insurance regulatory system in the States, represented by the National Association of Insurance Commissioners, is very concerned about pressures that work to cause companies to set up inadequate reserves. Such pressures conflict with the basic goal of insurance regulation which is to assure that insurance companies will have the resources to fulfill their commitments.

Finally, the Treasury proposal is related to an accounting theory which is being applied in an erratic fashion between various financial institutions. This is not a matter of a few drafting details but arises from Treasury's notion that it can easily redo the enormous work done in 1984 by several Congressional Committees and their staffs in devising new reserve rules. Treasury proposes to do this in an obscure section of a complex bill which would not attract the careful Congressional consideration such a change demands.

B. PROPOSED ELIMINATION OF THE SPECIAL LIFE INSURANCE COMPANY DEDUCTION

Presently, life insurance companies are allowed a deduction of 20% of their otherwise taxable income. The Treasury plan would repeal this deduction. The action of the Congress in enacting the deduction in 1984 was a serious effort to achieve a reasonable balance of effective tax rates between life insurance companies and other corporations, especially other financial corporations. The Treasury estimates a revenue increase of $4.5 billion for the period 1986 through 1990.

Why the Treasury Proposal Should be Rejected

1. The special deduction for life insurance companies was enacted to recognize that life insurance companies would be placed, if taxed on their full income as measured under the 1984 Act rules, at a significant competitive disadvantage relative to their competitors.

The legislative history of the 1984 Act indicates that a major impetus for inclusion of the life insurance company special deduction was to insure that life insurance companies could remain competitive with other financial intermediaries (e.g., banks, thrift institutions, self-insurance trusts, Blue Cross-Blue Shield, etc.). Congress believed that the deduction was necessary because the new life insurance company tax provisions broadened the tax base for life insurers but no attempt to broaden in a similar fashion the tax base for competing financial institutions. 2/

Although the Treasury proposal purports to put all financial services competitors on a "level playing field" by repealing certain tax benefits and deductions currently enjoyed by the various entities, it is not clear that the proposal would be completely enacted or, if enacted, will achieve competitive equality. While the simplicity of the life insurance company deduction makes it easy to estimate the tax effect of its repeal, the same cannot be said for the Treasury's proposals affecting other financial services and insurance institutions. In the years of deliberations culminating in the 1984 Act, much was learned about the

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2/ See. H. Rep. No. 98-432, 98th Cong., 1st Sess., Vol. 1, p. 111 (1983).

revenue effects of various proposals for life insurance company taxation. Since there has been no similar recent Congressional consideration of tax reform for banks and thrift institutions, tax-exempt insurance companies, Blue Cross and Blue Shield organizations, and self-insurance trusts it is much harder to predict with any certainty exactly what the tax effects of the Treasury proposals will be on these institutions.

For one thing, it is not certain that these institutions are on an equal tax footing under present law. By some estimates, for example, the effective marginal tax rate for banks may now be as low as 12-15%, in comparison with the 36.8% effective marginal rate for life insurance companies under present law after taking into account the deduction. 3/

At the same time, the Treasury's call for the repeal of tax-exemptions for "certain insurance organizations" is vague both as to the manner in which these institutions would become subject to tax and as to exactly which institutions would become taxable. Absent a much clearer definition of the proposed tax changes for such institutions, as well as extensive study of the impact Treasury proposals

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3/ See Treas. Dept. Report to the President, Vol. 2, p. 271 (Nov. 1984).

would have on effective tax rates for all financial institutions, there can be no assurance that the proposal accomplishes its goal of equal tax treatment for all businesses which sell insurance or provide financial services.

Finally, any study of competitive tax burdens is simply incomplete unless state and local tax burdens are included in the equation. Life insurers have traditionally paid a tax on gross premiums (whether there are earnings or not) to state and local governments. The "effective" tax rate on income represented by these taxes has been substantially greater than income tax rates or other taxes paid to states by competitor organizations. Unless and until this critical analysis proves otherwise, changes should not be made in the deduction for life insurers.

2. The special deduction for life insurance companies is an integral part of the comprehensive revision and simplification of the system for taxing life insurance companies enacted less than a year ago.

The special deduction for life insurance companies was enacted in 1984 as part of the first comprehensive revision of the federal income tax provisions for taxation of life insurance companies since 1959. The 1984 Act represents the culmination of several years of study and consideration of the appropriate framework for taxing life insurance company income. The 1984 Act is an integrated package of provisions intended to simplify the prior law's complexities while maintaining the delicate balance between stock and mutual life insurance company interests as well as competitive parity between life insurers and other financial services institutions. Each provision of the package, including the special deduction, is essential to the achievement of these goals. It is therefore inappropriate to consider in isolation the merits of one of these central provisions -- the special deduction -- even though the high visibility and easy comprehension of this provision may seem to invite such individual consideration.

According to the legislative history of the provision, one purpose of the special deduction for life insurance companies was to moderate the tax burden on the life insurance industry. (See Statement of John E. Chapoton, Assistant Secretary (Tax Policy) Department of the Treasury, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, July 28, 1983). To this end, there was much debate over the appropriate deduction percentage and Congress included in the Act a provision requiring the Treasury to study annually the effects of the law on the industry's relative tax burden beginning in July of 1985. For most companies, the first tax returns under the new law will not even be filed until September, 1985. Accordingly, it is too soon to determine the actual effective tax rates companies will experience under the new law. Many life insurance companies believe that even with the special deduction, their effective tax rate will be significantly higher than under prior law. Further changes in this system, such as the repeal of the special deduction, should be deferred until there has been an opportunity to evaluate at least one or two years of experience under the new law.

3. The special deduction replaced a number of complex deductions life insurance companies were allowed under prior law which recognized that the long-term nature of the life insurance business makes it difficult if not impossible, to measure the economic income of life insurance companies on an annual basis.

The special deduction for life insurance companies was included in the 1984 Act to replace a number of complex deductions life insurance companies were allowed under prior law. For example, under prior law, a life insurance company was allowed to defer taxation on one-half of its underwriting gain. According to the legislative history of that provision, Congress believed that because of the long-term nature of life insurance contracts, it is difficult, if not impossible, to determine the true income of insurance companies other than by ascertaining over a long period of time the income derived from a contract or block of contracts. Because of this, under prior law, life insurance companies were currently taxed on only one-half of their underwriting income with the other half added to a deferred tax account which, with limitations, was taxed only when it was distributed to shareholders.

The purpose of another of the deductions permitted life insurers under prior law -- a deduction for nonparticipating insurance -- similarly recognized the long-term nature of the life insurance business. This deduction was intended to create a "cushion" for companies selling non-participating policies to meet various contingencies when such contracts did not have the flexibility available to participating contracts with dividends that could be adjusted. Similarly, under prior law, life insurance companies were also allowed a special group insurance deduction (two percent of group insurance premiums), the purpose of which was to cover the hazards resulting from the fact that in group insurance there is geographic concentration of risk. Thus, the special deduction group insurance deduction, like the deferral of half of the underwriting gain and the nonparticipating insurance deduction also served as a "cushion" to meet contingencies not reflected in a company's economic income as reported on an annual basis.

The authors of the 1984 Act believed that these and other deductions under prior law added undue complexity to the system for taxing life insurers. Accordingly, they terminated these provisions and added the life insurance company special deduction. The Treasury's comprehensive tax reform proposal does not reflect the fact that the life insurance business will remain a long-term business with unique risks. The special deduction should not be discussed without study of what provisions might be needed to replace it to provide adequately for some of the contingencies mentioned above.

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CONCLUSION

We wish to thank the Subcommittee for the opportunity to address the impacts of the Treasury Department's proposals on the life and health insurance business and -- most importantly -- on our customers. We have urged that changes be made in the Treasury proposals in three areas. In each case, we urge that, since current tax treatment is logical and supports the public interest, the changes proposed by Treasury should not be adopted.

The great bulk of the taxes that would be raised by the Treasury proposals that we object to would fall on our customers -- the vast majority of American families. Although the Treasury report talks about eliminating tax distortions and about placing individuals and institutions on an equal basis, these proposals would raise taxes for millions of Americans and put added cost pressures on the mechanisms through which they obtain essential financial protection.

We would be glad to answer any questions you may have or provide you with any additional information you may need.

Chairman LaFalce. We will now hear from Mr. Lawrence Jones, the president of the American Insurance Association.

Mr. Jones. Mr. Chairman, we appreciate you filing our statement for the record but I would like, with your permission, to make two corrections in the statement as filed.

On page 4, the fourth line, we say that the net operating losses were $2.9 billion. We would like to change that to $3.8 billion.

And in the last line of that paragraph, the first paragraph on page 4, we report that the industry's capital structure is $60 billion. It's $63 billion.

Chairman LaFalce. Without objection, so ordered.

Mr. Jones. I would like to explain the change. The figures come from the same source, A.M. Best Co., but the first figures were their estimates in April and we now have their estimates in May. The financial statements were filed with the department as of the end of March. So this is a later estimate from the same source.

Also, may I request that you leave the record open for the Alliance of the American Insurers and the National Association of Independent Insurers, our colleagues in the property and casualty insurance industry, to file statements.

Chairman LaFalce. We would be delighted to do that.

STATEMENT OF T. LAWRENCE JONES, PRESIDENT, AMERICAN INSURANCE ASSOCIATION, ACCOMPANIED BY MAVIS A. WALTERS, SENIOR VICE PRESIDENT, INSURANCE SERVICES OFFICE, INC., WASHINGTON, DC.

Mr. Jones. My name is T. Lawrence Jones and I am president of the American Insurance Association, and I am accompanied by Mavis A. Walters, senior vice president of the Insurance Services Office. We are here representing the American Insurance Association and its 175 companies. They write more than $40 billion in premium volume each year.

The Treasury proposal, Mr. Chairman, would have a very serious effect on the industry. In some cases, it would have a disastrous effect.

The key part of the proposal is to reduce artificially the amount of money we set aside for reserves for the payment of losses, and it proposes to do this at a time when the industry needs all the strength it can have—we are generally in a weakened condition because of net operating losses in recent years and particularly last year, and at a time that the solvency of a number of companies is threatened. I can tell you that a number of them are looking for purchasers that have greater capital to make available to them.

It also occurs at a time when the industry is having a great deal of difficulty meeting the demand for insurance. Under the regulation of insurance the regulators look at the ratio of the premium writings to the capital structure available. Generally this should run about $2 of premium to $1 of capital structure. The warning line or the red line shows when they get up to $3 of premium to $1 of capital.

Because of the reduced premium levels in recent years and the fact that they are of necessity rising, the fact is that the capacity of the companies to continue to write and take on new business is limited. They don't have the capital structure to do it.

You have probably observed through the financial press that the larger companies are going to the financial markets for more capital. The smaller companies are not in that position and it is much more difficult for them to go to the financial markets. So that has been quite a problem.

The irony of the Treasury proposal is that its proponents come before the Congress and the public saying that they are trying to simplify the tax system and to make it more fair. Yet this proposal creates the greatest complication that you can imagine for insurance companies and a very unfair one.

The history of our industry is that our companies have underreserved. The dynamics of the industry is if you put away more reserves than you need, then you show a poorer performance as compared with other companies. Managements just don't do this. They measure their performance against other companies and they go to their board and explain how they are doing relative to others. If you look at the industry, all the adjustments that have taken place have taken place to increase reserves. They have underestimated reserves. So there's really not a problem here from the Treasury's point of view of the industry underreserving because we are taxed on the bottom line and all other industries are taxed on the bottom line, and that is the theory of the income tax—that it would be on a net income tax basis.

Yet this proposal—and I have a great deal of difficulty explaining the qualified reserve account—I usually have to read it. I have tried on a number of occasions to explain it, but it's certainly a concept foreign to the property and casualty industry and has a very poor application to it if it can be applied at all. But the way it would operate here is it would cause us to pay a tax to the Federal Government estimated by the Treasury at $3 billion a year, regardless of whether we had a net operating loss or net income at all. So that is foreign to the concept of a net income tax which is what we are supposed to have.

Another thing that it does is to encourage self-insurance and unregulated insurance. Unregulated insurance includes not just domestic companies that are not licensed in a particular state writing excess and surplus lines, but it also applies to these off-shore companies that are based in Bermuda and the Cayman Islands and come in on an unregulated basis. The only justification for those is that they are avoiding income taxes and that they are avoiding premium taxes and this would certainly do nothing but aggravate that. There is no way that the Treasury proposal can help us with our balance of payments. It will tend to increase the advantage of non-U.S. insurance companies and thus be to our disadvantage on our balance of payments.

We find that the basis for the proposal is not applicable to the property and casualty insurance industry. It is very unfair and burdensome at a time that we are having difficulty performing our basic function of making insurance available, and it threatens the solvency structure of the companies which is the basic function of the state regulatory system and, it will imperil that. Furthermore, a number of insurers are in a position of having to supplement their capital in some way or other now and this would just aggravate it more.

We appreciate the opportunity to be here and your courtesy in having us here. We are prepared to answer any questions and go into any depth that you would like us to.

Chairman **LaFalce**. Thank you very much, Mr. Jones. I do have a number of questions, but I will defer them until the conclusion of the panel's presentations.

[Mr. Jones' prepared statement, on behalf of the American Insurance Association, follows:]

STATEMENT OF T. LAWRENCE JONES ON BEHALF OF AMERICAN INSURANCE ASSOCIATION

Mr. Chairman and Members of the Subcommittee, I am T. Lawrence Jones, President of the American Insurance Association. I am pleased to have the opportunity to appear before you today.

The American Insurance Association is a trade association representing 174 casualty and property insurance companies, which are predominantly organized as stock companies. The member companies of AIA had a total premium volume in 1984 of $39.3 billion or 33% of the $118 billion of the direct premiums written in the United States. The member companies write all types of personal and commercial coverage.

The announcement accompanying the notice of this hearing stated the Subcommittee's desire to receive testimony regarding the impact of the Treasury Department's tax proposal on the casualty and property insurance industry. The impact on our industry would be, in a word, devastating.

The Treasury Department has used the innocuous terms of tax simplification, fairness and promotion of economic growth to advance its tax proposals. Although I have not discussed the proposals with other industries, discussions with executives in my industry as well as my knowledge of the difficulties the casualty insurance business is currently facing leads me to the following conclusions:

- First, as it affects our industry, the proposal will require substantial cost increases and will affect availability of all types of casualty insurance.

• Second, it imposes a substantial competitive burden on United States casualty and property insurers.

• Third, the use of unregulated self-insurance will be encouraged as an alternative to purchased insurance.

• Finally, the proposal undermines the most basic element of state regulation of insurance--insurance company solvency and the protection of insurance policyholders.

The most significant proposal for my industry and the only one that affects all casualty insurers is one that would place a restriction on the amount of funds insurers can place in loss reserves by requiring estimated future losses to be discounted back to their present value. The discounting would be accomplished by the use of an otherwise fictional Qualified Reserve Account (QRA) for each line of business for each policy year. The QRA is designed to take into account, on an after-tax basis, investment income a company is presumed to be able to earn in the future.

The QRA would allow an insurance company to deduct a loss reserve, in the year it is established, in an amount that is less than the total loss payable. The thrust of this proposal is to require insurers to determine the estimated time when claims will be paid, the estimated amount of the claims to be paid and the company's estimated after-tax rate of return on its investment assets. The initial reserves set aside, however, could never exceed the net amount of premiums received after deducting the acquisition expenses related to writing the insurance policy.

I. The QRA Will Result In Increased Premiums And May Reduce Capacity

One of the most respected insurance analysts, Robert A. Bailey, Vice President of the Property/Casualty Division of A. M. Best Company, the organization that rates insurance company solvency, has predicted that if the QRA were enacted into law, the increase in federal taxes for the casualty insurance industry would be equivalent to 4% of earned premiums each year, which in 1984 would have produced $4.7 billion in tax revenue. In order to make up for the lost income, as well as the additional commissions, state premium taxes and other overhead expenses, the industry would be forced to increase premiums from 15% - 32%, depending on the line of business. Mr. Bailey has estimated that premium increases of 32% would be necessary for medical malpractice, 24% for general liability, and 15% for workers' compensation and reinsurance. In short, he predicts that there will be an overall average rise of 11% for the industry.

The ability of a casualty insurer to write new business or assume higher limits of liability is a function of its available surplus. The general rule used by insurance regulators and companies is that a company's written premiums should be no greater than three times its capital and surplus. Thus, absent an increase in premiums by the full amount of the additional tax burden, the industry's surplus and consequently insurance availability will be reduced significantly.

The Insurance Services Office, Inc. (ISO), the industry's rating service, predicts that--due to recent historic losses--available casualty and property insurance may fall short of demand by $62 billion over the next three years. This prediction does not take into account the impact of the Treasury's tax proposal on the industry's surplus.

The depletion in surplus is a direct result of the successively larger underwriting losses experienced by the industry each year for the past six years. In 1984, the industry had over $21.3 billion in underwriting losses and $3.8 billion in pre-tax net operating losses. A. M. Best Company has estimated that the industry will incur underwriting losses of $23 billion in 1985. As a consequence of these losses, the industry's surplus has declined from $65 billion to $63 billion.

The current capacity shortage facing the industry is directly related to this reduction in policyholder surplus. Unfortunately, however, at a time when the industry's ability to meet the needs of the insurance marketplace is precarious at best, the Treasury's proposal would reduce surplus even more, thereby exacerbating the availability problem. By the Treasury's own estimates, the casualty insurance industry's tax burden will be increased by approximately $3 billion per year.

II. The QRA May Increase The Share Of The U. S. Casualty Insurance Market Held By Non-U. S. Insurers

Even if the industry were not facing such difficulties, the competitive nature of the insurance business would never permit the drastic premium increases that would be necessary under the Treasury's proposal. The U. S. insurance industry competes in an open-ended world market. Because the barriers to entry into the U. S. insurance market by alien (non-U. S.) insurers are few, U. S. insurers could not expect merely to pass on any increased tax burden to their customers in the form of higher prices.

The Treasury's QRA proposal could confer a substantial advantage on those alien insurers that either are not subject to any U. S. income taxes or can offset increased U. S. taxes against their own country's tax through the use of credits allowed for foreign taxes paid. The Treasury's proposal, therefore, must be examined beyond its ability to generate new revenue for the government. Such an analysis must take into account the effect on consumers and U. S. commerce.

Since casualty insurers must compete in a global economy, any proposal that increases operating costs for U. S. insurers but not for overseas competitors can be expected to result in greater penetration of the U. S. insurance market by foreign competition. Moreover, as the cost of insurance increases for American businesses, many businesses will seek lower cost insurance coverage overseas, further compounding the U. S. balance of payments problem. Lastly, U. S. insurers forced to absorb additional taxes will find it even more difficult to compete in overseas markets.

As members of this Subcommittee are well aware, the U. S. has been incurring enormous trade deficits competing in the world market in the sale of its goods and services. In 1984, the U. S. had a balance of payments deficit of $90.4 billion in trading its goods and services. Although a large portion of that is attributable to the strong U. S. dollar stemming from the severe federal deficits, any proposal which would further aggravate the trading deficit should be rejected.

III. The QRA Encourages The Use Of Self-Insurance By Creating A Further Bias Against Purchased Insurance

In proposing the QRA, the Treasury has stated that its enactment will level the playing field between self-insurance and purchased insurance by eliminating the favorable tax status of commercially purchased insurance. This contention, however, ignores the whole purpose of insurance. Fundamental to the concept of insurance is the reduction of the cost of risk to the insured.

Because insurance is purchased to minimize future risk of loss, whether from natural or man-made events, state law requires casualty and property insurers to maintain mandatory reserves, meet certain investment standards and contribute to guaranty funds to protect policyholders in the event an insurer becomes financially impaired. These are requirements that commercial insurers--but not self-insurers--must meet to do business in the U. S. Moreover, because they are regulated by the individual states, the casualty insurance industry pays state premium taxes in all states they write insurance in. In 1984, the industry paid $3.8 billion in state premium taxes.

The Treasury's ORA proposal does nothing to change these requirements. Instead, by placing financial penalties on the accumulation of funds to assure payments for accidents and catastrophes, the Treasury is offering another incentive to self-insure risks.

IV. The ORA Will Undermine State Regulation of Insurance

Any proposal that would reduce the funds available to pay claims serves to undermine the major goal of state regulation of the insurance industry: the protection of insurance policyholders and claimants against insurance company insolvencies.

California Insurance Commissioner Bruce Bunner, in a letter dated March 26, 1985, to the Treasury Department on behalf of the National Association of Insurance Commissioners' Property and Casualty Taxation Task Force stated:

> "The insurance industry is highly fiduciary in character and protection of insureds should be the paramount concern. Discounting loss reserves as proposed fails to achieve the Treasury's reform criteria and works against the states' goal of maintaining insurer solvency. The proposal is a disincentive for adequate insurance reserving and is not in the public interest."

The importance of setting reserves appropriate to meet both reported losses and those which have been incurred but not reported has also been recognized by Congress in federal tax law since 1921. It is for this reason that taxation of the insurance industry has been based on the data required to be filed with state insurance commissioners in Annual Statements.

The application of the Treasury Department's QRA proposal would do exactly what state and federal law have attempted to protect against for over 60 years. In its attempt to generate tax revenue from casualty insurers, the proposal would inflate taxable income so that it exceeds economic income. This proposed change in the tax treatment of the industry goes against the principle of integrating sound tax policy into public policy.

The current method of using statutory accounting principles to measure taxable income of insurance companies allows insurance regulators, business and consumers to evaluate the ability of an insurance company to respond to obligations assumed under contracts of insurance. To the extent that federal tax policy would require the use of different and conflicting financial data by the casualty insurance industry, there would be serious implications for both policyholders and regulators. Policyholders would receive different signals from different government agencies. The regulation for solvency would be compromised and the public would lose the sense of security it currently has in the protection provided by the industry.

CONCLUSION

AIA supports the goal of the Administration and Congress to reform and simplify federal tax laws. Our members would endorse a proposal that truly promotes economic growth and encourages competition between both domestic and foreign insurers.

Any proposal, however, that results in significant increased costs for individuals and businesses, presents serious questions concerning international trade, encourages unregulated self-insurance, and threatens the financial well-being of casualty insurers and their policyholders can not truly be called tax reform or tax simplification.

It is inappropriate and unwise for the Administration to suggest a fundamental change in the federal tax code, which would force an illusion of profitability on an industry that has suffered through six years of succeedingly larger losses. Such a change would have catastrophic consequences, not only for the casualty insurance business, but for U. S. commerce, business and consumers alike.

We urge you to consider these factors as you examine the Treasury Department's tax proposals.

Chairman LAFALCE. I am now pleased to call upon Mr. Robert Hunter of the National Insurance Consumer Organization, who I believe will give us a slightly different perspective on the Treasury Department's tax proposals. Mr. Hunter.

Mr. HUNTER. Thank you, Mr. Chairman. It's nice to see you again.

Chairman LAFALCE. Because we've got two against one, Bob, I will give you a little bit more time.

STATEMENT OF J. ROBERT HUNTER, FCAS, NATIONAL INSURANCE CONSUMER ORGANIZATION

Mr. HUNTER. I represent the National Insurance Consumer Organization, as you pointed out, and I do appreciate your invitation. I was out of the country until just recently, so I apologize that my statement was late and, because of that, I am not going to comment today on life insurance, but our actuary is working on a statement on life insurance which will be——

Chairman LAFALCE. You put a cloud on Mr. Schweiker's day.

Mr. HUNTER. We would like to submit our statement on the life insurance part within a week if that's satisfactory.

Chairman LAFALCE. Surely.

Mr. HUNTER. I will comment, however, on the property and casualty part.

Attached to my testimony is a copy of a study we did. It's a copywritten study but I'm freeing you to use it at this time. It's on the GAO report which covers a lot of the same issues.

The key findings of our study are as follows—this relates to property and casualty as I said—the proposal to discount loss reserves is sound and should be adopted by Congress. There is no actuarial, economic or insurance theory argument against the proposition that reserve discounting makes sense. Anybody in the country can tell you about the time value of money after recent inflationary times.

Reflection of time value of money as respects reserves using imbedded investment yields and historic claims settlement practices is appropriate, actuarially. The timing for this proposal fits perfectly with the similar action of the National Association of Insurance Commissioners as respects ratemaking, where they have now adopted an approach which in effect reflects the time value of money on reserves in establishment of prices. This is much more important than the tax impact which is estimated at the very most at six-tenths of 1 percent.

The discounting of loss reserves for tax purposes poses no threat to solvency since the State rules will be unaffected by Federal tax policy. State regulation is quite capable of establishing distinct rules for solvency regardless of what Congress does vis-a-vis taxes. The property-casualty insurance industry is hardly in terrible shape, their protestations to the contrary notwithstanding. Their stock market performance continues to be magnificent. And I attach a chart to my statement which shows the stock market performance through 1982 and you can see how remarkable it is.

Since 1982, the Best property-casualty index has risen by 40 percent through last Friday compared to 19 percent for the Dow Jones Industrial Average. In 1985, the property-casualty stock index rose 20 percent compared to 3 percent for the Dow Jones Industrial Average.

As recently as yesterday, Best—a source which has already been mentioned—in their Advanced Rating Report noted that: "The industry has ample reserves available to meet contingencies with liquid assets equal to 31 percent for liabilities and total unaffiliated investment exceeding liabilities by 4 percent—underwriting commitments are reasonable in relation to net resources."

The discounting of loss reserves for tax purposes will not affect insurance prices for personal lines by 1 cent. Ratemaking practice does not reflect timing of taxes even in those few instances where taxes are even reflected. By far the majority of States do not require analysis of profitability of insurers when rates are set, as shocking as that fact is in 1985. Regulation of insurance has ignored investment income until last June. That was "tantamount to discarding price regulation altogether." Even in the States that do reflect total return in establishing rates, only the tax rate is applied in setting rates, not the timing of taxation. Therefore, there will be zero impact of this change on personal lines ratepayers.

Commercial ratepayers may have a modest impact on their prices. Not the small ones. The large ones might have an impact estimated to be no more than six-tenths of 1 percent.

The GAO approach to discounting appears simpler and easier for insurers to implement than the Treasury approach. Both should, over the long pull, produce the same additional tax revenues. The data necessary to do the GAO type calculation are readily available in insurance company files and present no technical problem whatsoever to implement.

The industry arguments that solvency, underwriting, profits and State regulation of insurance will be somehow, mysteriously, undermined by sound tax policy are simply red herrings. These are all within the domain of State regulation, and these proposals do not alter the effectiveness or ineffectiveness of State regulation one whit.

We have seen in previous written comments in the GAO context that there are claims that, besides these awful things happening, no additional revenues will be generated, I don't think they can have it both ways. I think what will happen is very modest additional revenues will be generated for the Treasury and no significant adverse impact on insurers will be felt.

The argument that proper taxation is anticonsumer is not valid. As the argument goes, it claims that there will be an incentive to delay claims to match the discount model employed. The incentive to delay claims is related more to the available interest rate than to the timing of taxes. Taxing sooner, if anything, reduces the incentive to delay claims since, the faster the company pays this year, the shorter the discount period it will use next year and, thus, the less tax it will pay up front. In fact, it will eliminate such abusive practices as retroactive insurance which should be eliminated and which you will recall, in the *MGM* case, led to very slow claims payment behavior in order to try to make the deal work. This has just recently been settled in court.

The claim that insurance will be lost to foreign competition if reserve discounting is used for taxation purposes is invalid. Competition from foreign markets is controlled by larger issues than this, such as costs of delivery of insurance and the cost of the administration. Further, the States require insureds to demonstrate inability to purchase insurance domestically prior to approaching the nonadmitted market. I can't imagine a six-tenth of a percent rise in price potential for some commercial accounts making the insured able to claim inability to purchase.

There are other additional proposals in the Treasury proposal. Elimination of the protection against loss account, the repeal of miscellaneous special tax exemptions, and the proposed limit on mutual property/casualty policyholder dividend deductions and we agree with all those proposals.

There's also a proposal to repeal the tax exemption for certain nonprofit insurance companies. We think that requires careful analysis. NICO supports repeal for the insurers who act like normal insurers in the transaction of business, however there may be instances where there is good cause to grant an exemption from taxation in order to encourage cooperative response to some kind of insurance market dislocation, possibly like black lung or an urban crisis or something like that.

And I encourage you to review carefully who currently is getting coverage under today's exemptions prior to taking final action on that proposal.

Finally, one thing not mentioned in the Treasury report that is covered by GAO is the allocation of acquisition costs over the life of insurance contracts. GAO recommended such action. The NAIC and insurers make such adjustments to the annual statement to adjust the conservative statutory accounting base to a more realistic GAAP base. I discuss that at length in my prepared statement. I think it's a good proposal and should be adopted.

I would be happy to answer any questions you have.

Chairman LaFalce. Thank you very much, Mr. Hunter.

[Mr. Hunter's prepared statement and study, on behalf of the National Insurance Consumer Organization, follows:]

NATIONAL INSURANCE
CONSUMER ORGANIZATION

Statement of

J. ROBERT HUNTER, F.C.A.S.

Before the Subcommittee on Economic Stabilization
U. S. House of Representatives

May 8, 1985

RE: TAXATION OF INSURANCE COMPANIES

344 Commerce Street
Alexandria, Virginia 22314
(703) 549-8050

Mr. Chairman and Members of the Subcommittee, it is a pleasure to appear before you to discuss the important topic of insurance company taxation, or more accurately, lack of it.

I represent the National Insurance Consumer Organization, a non-profit public interest group that studies insurance issues. We are the only private organization in the country that is constantly reviewing insurance issues from the perspective of the public.

I am a casualty actuary, a Fellow in the Casualty Actuarial Society and a Member of the American Academy of Actuaries. I have served ten years in the private sector insurance business as an actuary making property and casualty insurance rates for most companies as an employee of rating organizations in New York. I also served ten years in the federal government with the Federal Insurance Administration, serving as Administrator, Deputy Administrator and Chief Actuary.

I apologize for not getting an advance copy of my statement to you. As I told your staff, I just returned from a trip to Africa and did not know of the opportunity to testify until last Friday. Because of the brief time available, I have decided to limit my remarks to the property-casualty tax questions, an area in which NICO has done considerable research. I request, however, that we have the opportunity to submit written remarks regarding life insurance taxation. I will ask our life insurance actuary to comment quickly.

I attach and incorporate into this testimony a copy of NICO's January/February Newsletter which is a discussion of the tax issues raised regarding property-casualty insurance. While the context of the Newsletter article is the GAO Report \1 , the issues are the same as those raised by the Treasury Department.

The key findings of NICO' study into taxation of property/casualty insurance companies are:

* The proposal to discount loss reserves is sound and should be adopted by the Congress. There is no actuarial, economic or insurance theory argument against the proposition that reserve discounting makes sence.

* Reflection of the time value of money as respects reserves using imbedded investment yields and historic claims settlement practices is appropriate, actuarially. The timing for this proposal fits perfectly with the similar action of

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\1 Congress Should Consider Changing Federal Income Taxation Of the Property/Casualty Insurance Industry, General Accounting Office, March 25, 1985.

the National Association of Insurance Commissioners as respects ratemaking \2

* The discounting of loss reserves for tax purposes poses no threat to solvency since the state rules will be unaffected by federal tax policy. State regulation is quite capable of establishing distinct rules for solvency regardless of what Congress does *vis-a-vis* taxes. The property/casualty insurance industry is hardly in terrible shape, their protestations to the contrary notwithstanding. Their stock market performance continues to be magnificent. As you can see from the attached chart, the property/casualty industry has had exceptional stock market performance in recent years. Since the chart, which I could not update due to the brief time I had to prepare for the hearing, the Best's Property Casualty Stock Index has gone up (through Friday, May 3, 1985) by 40% (over 20% in 1985 alone) compared with an increase in the Dow Jones Industrial Average of 19% since 1982 (under 3% in 1985). The property/casualty insurance industry continues to be a darling of investors despite large underwriting losses. As recently as yesterday, Best's Advance Rating Report noted that the industry has "ample resources . . . available to meet contingencies with liquid assets equal to 31% for liabilities and total unaffiliated investment exceeding liabilities by 4% . . . . Underwriting commitments are reasonable in relation to net resources . . ."\3

* The discounting of loss reserves for tax purposes will not affect insurance prices for personal lines (auto, homeowners, etc.) by one cent. Ratemaking practice does not reflect timing of taxes even in those few instances where taxes are even reflected. By far the majority of states do not require analysis of profitability of insurers when rates are set, as shocking as that fact is in 1985. Regulation of insurance has ignored investment income until last June. That was "tantamount to discarding price regulation altogether". \4 Even in the states that do reflect total

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\2 Report of the Investment Income Task Force, NAIC, June, 1984. The full NAIC adopted this approach, which effectively discounts loss reserves for ratesetting, at their National Convention in New Orleans in June of 1984.

\3 Best's Advance Rating Report, May 6, 1985.

\4 Investment Income and Profitability in Property/Casualty Insurance Ratemaking, John W. Wilson and J. Robert Hunter, January, 1983.

return in establishing rates, only the tax rate is applied in setting rates, not the timing of taxation. Therefore, there will be zero impact of this change on personal lines ratepayers. \5

* Commercial ratepayers may have a modest impact on their prices, but it will be *de minimus*. Small, manually rated risks will not be impacted for the same reasons as above for personal lines. Larger, individually negotiated risks will likely feel a minor impact, estimated to be no more than 0.6%

* The GAO approach to discounting appears simpler and easier for insurers to implement than the Treasury approach. Both should, over the long pull, produce the same additional tax revenues. The data necessary to do the GAO type calculation are readily available in insurance company files and present no technical problem whatsoever to implement.

* The industry arguments that solvency, underwriting, profits and state regulation of insurance will be somehow, mysteriously, undermined by sound tax policy are simply red-herrings. These are all within the domain of state regulation, and these proposals do not alter the effectiveness (or ineffectiveness) of state regulation one whit.

* It is somewhat amusing to hear the arguments that all of these dread things will happen simultaneously offered with the argument that no additional revenues will be generated by adoption of reserve discounting. They can't have it both ways. Modest additional revenues will be generated for the treasury and no significant adverse impact on insurers will be felt.

* The argument that proper taxation is anti-consumer is not valid. As the argument goes, it claims that there will be an incentive to delay claims to match the discount model employed. The incentive to delay claims is related more to

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\5 See NAIC, op cit. The models proposed for achieving total return ratemaking found on pages 49-80 would not vary the rate if this tax change were adopted. One possible exception to this might be State Farm which uses actual total return in selecting a profit margin but the impact will be no more than 0.6%.

the available interest rate than to the timing of taxes. Taxing sooner, if anything, will reduce the incentive to delay claims since, the faster the company pays this year, the shorter the discount period it will use next year and, thus, the less tax it will pay up front. In fact, it will eliminate such abusive practices as retroactive insurance which, you will recall, led to slow claims payment behavior by the involved insurers.

- The claim that insurance will be lost to foreign competition if reserve discounting is used for taxation purposes is invalid. Competition from foreign markets is controlled by larger issues than this, such as costs of delivery and administration. Further, the states require insureds to demonstrate inability to purchase insurance domestically prior to approaching the non-admitted market.

- The proposal to eliminate the Protection Against Loss (PAL) account, a tax break for mutual property/casualty companies is sound and should be adopted by the Congress.

- The repeal of miscellaneous special tax exemptions, rate reductions and deductions of small mutual property/casualty companies is sound and should be adopted by the Congress. They are arbitrary and encourage unfair competitive practice.

- The proposed limit on mutual property/ casualty policyholder dividend deductions to that given life insurance mutuals (based on the 1984 overhaul of the life insurance tax code) is sound and should be enacted by Congress.

- The Treasury proposal to repeal the tax exemption for certain non-profit insurance companies requires careful analysis. Certainly, NICO supports such repeal for those insurers who act like "normal" insurers in the transaction of their business. However, there are instances where there is good cause to grant an exemption from taxation in order to encourage true cooperative response to insurance market dislocations. I think of the black lung trusts as an example of this sort, or of responses to crises such as the urban riots of the late 1960's. I encourage you to review carefully who gets coverage under today's exemption prior to taking final action on this proposal.

- Finally, I encourage you to adopt legislation to require allocation of acquisition costs over the life of the insurance contracts. This was recommended by GAO. The NAIC and insurers make such adjustments to the Annual Statement to adjust the conservative statuatory accounting base to a more realistic GAAP base (this is discussed at length on page 2 of the NICO Newsletter, attached).

I will be happy to respond to any questions you might have at this time.

NICO NEWSLETTER
TO: Our Subscribers
FROM: Bob Hunter

January/February, 1985
Volume IV, Number 1

INSIDE: NICO Analysis of GAO Report: "Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry."

GAO suggests the Congress re-examine three areas of the IRS Code as it pertains to property/casualty insurance, viz:

- o the deduction for loss reserves, in that the deduction currently ignores the time value of money. GAO's opinion is that this value should be recognized through discontinuing reserves;
- o the deduction for expenses associated with the sale, including renewal, of insurance policies, in that expenses are not allocated currently in a way that matches premium revenues associated with them. GAO's opinion is that such matching should occur by allocation of such costs over the life of related contracts; and
- o the deferring of part of a mutual company's income, through the Protection Against Loss (PAL) account. GAO's opinion is that this deferral should be re-examined by the Congress.

These three recommendations can hardly be described as exceptional. As respects loss reserves, GAO recommends that the time value of money should be reflected by discounting, for tax purposes only, the reserves based upon imbedded (individual insurer actual) yields and historic claim settlement patterns. This recommendation is timed almost perfectly vis-a-vis the National Association of Insurance Commissioner's (NAIC) decision to move in a similar direction as respects regulatory ratemaking. /1 In their Report, the NAIC adopts total return ratemaking which effectively discounts loss reserves when rates are established. The reason for this "chance" movement by both NAIC and GAO in the same direction is not chance at all, but a growing recognition of the reality of insurance practice, that fully funded reserves generate large amounts of income during the time they are held by insurers. This reality has become more noticable in recent years. As the NAIC puts it, "High interest rates have fostered in almost everyone a keen awareness of the time value of money." /2 For the NAIC, this keen awareness led to a report on how to reflect the time value of money in pricing; for the GAO, the same awareness manifested itself in the Report on Property/Casualty Taxation.

There is simply no argument in actuarial, economic or insurance theory against the proposition that loss reserve discounting makes sense. /3 The only possible exception to that, which is quite debatable, is the area of solvency testing where regulators have been super conservative in making such decisions. There is, however, no question of the soundness of discounting of loss reserves for tax

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NICO, 344 Commerce Street, Alexandria, Virginia 22314.

purposes (and for other purposes). To not do so is to allow the insurer/taxpayer a profit on the tax transaction, roughly equal to the investment income on the tax savings between loss reserve establishment and loss payment, an advantage other taxpayers do not enjoy.

As respects acquisition expenses, GAO recommends that the tax code be amended to provide that acquisition costs be allocated over the life of related contracts. This is again an unexceptional recommendation; one which should be non-controversial. Insurers routinely make this adjustment to their Annual Statements, statutory accounting principles (SAP)-basis, approach in preparing their reports to stockholders on a more realistic, generally accepted accounting principles (GAAP) approach.

In their above-cited Report, the NAIC states:

> A significant protion of the unearned premium reserve may be offset by the cost of acquiring business. This includes commissions, premium taxes, other acquisition expenses, and a protion of general expenses. Under SAP, these items are recognized as an expense when premiums are written. Under GAAP, which attempts to match expenses with their related income, acquisition costs are not recognized as an expense until the premiums to which they relate are earned. The acquisition costs related to unearned premiums are treated either as prepaid expenses, which is a separate asset item, or as an offset to the amount of the unearned premium reserve. Under either treatment, it can be seen that when these costs are not expensed, net income will be higher than it is under SAP. Net worth will also be greater. In adjusting from statutory surplus to GAAP net worth, a cumulative adjustment must be made for the prepaid expenses related to the entire unearned premium reserve. In adjusting from a statutory underwriting profit to a GAAP underwriting profit, the increase in prepaid expenses for the current year must be reflected.
>
> The increase in prepaid expenses is sometimes considered to be a relatively unimportant accounting adjustment. Two points should be made clear. First, it should be understood that the statutory accounting principles are designed to reflect solvency and are very conservative in the sense that, in comparison with a GAAP calculation, both income and equity are usually understated. The reflection of prepaid expenses is a needed adjustment to the financial data to allow it to be compared to that of other industries. A second point is to note the amount of income involved. In the last twenty years, the increase in prepaid expenses for all companies amounted to approximately $6.8 billion, or more than the statutory underwriting loss for that period.

Thus, it is clear that the recommendation of GAO is simply reflecting a reality that insurers and regulators alike recognize.

The third recommendation of the GAO Report is likewise unexceptional. It merely calls for Congressional consideration of whether the PAL account should be continued. PAL defers taxes on a portion of mutual insurer's underwriting income.

It seems that Congress, in writing this provision of law, has interposed itself directly into the domain traditionally reserved for state regulation: the question of solvency of insurers. The rationale for PAL seems to be based on the mutuals inability to augment surplus via access to capital markets.

State regulation is fully capable of devising the necessary capital and surplus requirements for different categories of insurers. To have special interest tax rules such as PAL seems to imply that state regulation cannot achieve its primary function of protecting the public against insurer insolvency.

Surely, with no stockholders to service, mutual insurers have the competitive edge and can and do grow (State Farm is a sparkling example). PAL is really a redundancy.

In any event, since GAO merely calls for review of PAL by Congress, it is difficult to seriously challenge such a recommendation.

TREASURY COMMENTS

In implementing loss reserve discounting, Treasury proposes a more far-reaching method for accomplishing the adjustment. While the Treasury method has some theoretical appeal, it appears to create a very serious practical problem in implementation -- namely, that each case basis reserve be discounted to the expected payment date of that individual accounting mechanism. The GAO approach is do-able, under current accounting capacity, using aggregate loss payout patterns already used by insurers in much of their ratesetting.

In any event, it is clear that Treasury fully supports the concept of reserve discounting.

Regarding expense allocation, Treasury supports the GAO approach.

Regarding the PAL account, Treasury goes further than GAO and calls for the elimination of PAL, a position we believe is justified.

INDUSTRY (INCLUDING NAIC) COMMENTS

The industry and NAIC comments are essentially negative. Many of their comments, however, are really non-sequitors, having more to do with the quality of state regulation than sound federal tax policy. These non-sequitors include:

- Solvency;
- Underwriting;
- Profitability; and
- The undermining of state regulation.

These arguments are irrelevant to sound tax policy, and are matters for state regulatory oversight. If profits are too low (something the stock market performance of property/casualty belies), if reserves are understated, if solvency is threatened, these are serious concerns for state regulation which has dealt with them historically before and after many previous tax law changes. The argument seems to be that the federal government should "bail-out" insurers by keeping inappropriate tax policies in place. If state regulation is unable to cope with these issues, and a federal "bail-out" is needed (it is not, in NICO's view), it should be done up-front, a la Chrysler, and not through tax loopholes.

The argument that making these changes will undermine state regulation is not valid. As the Financial Accounting Standards Board states, "Many situations exist where transactions are recognized differently for accounting purposes and income tax purposes. For example, state and municipal bond interest is included in accounting income, but is excluded from federal taxable income." /4 Thus, FASB makes it clear that the tail does not wag the dog in these matters. If reserves are discounted for tax purposes it is not axiomatic that they must be for statutory accounting. That is up to the states to decide, and they will do so.

Other arguments made by the industry are more relevant than the above. They include:

- Complexity of calculation of discounted reserves;
- The charge that GAO misunderstands how insurance is priced;
- GAO revenue estimates are unrealistic;
- Foreign competition was ignored by GAO;
- Self-insurance and captives would be aided;
- GAO's policy would lead to anti-consumer behavior to hold up claim payments to match the discount model; and
- The lack of justification for Treasury collecting a heavier tax if the loss is reimbursed one year later than if it is reimbursed immediately.

Each issue is addressed below:

Complexity: The Treasury approach appears complex, requiring extensive new accounting methods. The GAO approach is straightforward and feasible. Insurers routinely produce cash flow and what is known as "loss development" exhibits. Cash flow exhibits are usually not given to regulators, but insurers produce them for management. Loss development type exhibits are routinely produced by filers. Through its use, the actuary projects current reserves to an ultimate paid basis. Loss development is available on a paid loss, outstanding loss and, the sum of the two, incurred loss basis. It is a fundamental building block of ratemaking in many lines for most filers. It lends itself perfectly to the GAO approach in that it can be used to calculate how long the historic claims took to settle.

The imbedded yield that GAO chooses to use, a moving average, is also readily available. It is questionable that a five-year moving average is needed since swings in yield are not wide but modest, but some such convention is necessary.

The only area of concern NICO has with the Draft Report on this point is for small companies, including new companies. One or two claims can greatly distort payout patterns for such insurers. New companies don't even have any history to rely upon. It seems to us that Treasury regulations should allow smaller insurers the capability of using some averages based on industry average histories for the purpose of establishing needed factors.

The charge that GAO misunderstands how insurance is priced relates to certain examples in the Report. GAO does not claim that this is the actual pricing mechanism but that it is a hypothetical to show the effects of discounting and not on net income. In fact, ratemaking would be different than what GAO portrays, it being based in most cases on such additional items as undiscounted reserves, trends, expenses and profit provisions.

However, GAO's example's are valid evidence of the effects of discounting on tax implications. The result will hold true when real world additional ratemaking factors are utilized.

GAO revenue estimates are unrealistic: GAO admits that changes in investment portfolios, the effect of loss carryovers and phase-in will impact its projections, although the latter two will only do so temporarily. In any event, sound tax policy should not be predicated upon knowing the tax impacts to the penny, but on what is right in theory, not really challenged by the industry.

Finally, the commentators indicated that premiums would rise to cover this tax amendment, an issue which will be discussed in considerable detail below.

What the commentators failed to point out is the significant underestimation of current additional taxes that is likely given GAO's use of 5, 6 and 7% earnings rates in Table 5. It is likely that higher earnings rates will be seen for some companies at once and most quickly.

Regarding the foreign competition point, the discounting of reserves in taxation only would marginally adversely affect domestic insurers if at all. If they went all the way and discounted in pricing and in accounting, the effect would likely be positive in that surplus would increase.

The reason the effect is marginal is that there would be a slight cash drain with no surplus relief. If the accounting followed the IRS, then surplus would be increased and domestic insurers would improve their competitive stance.

Foreign business is not a major factor in personal lines (about 1/2 of the volume of property/casualty insurance). The issue is limited pretty much to large commercial accounts where the real competition is with self-insurance and off-shore captives (a sort of "foreign" insurance).

The effect of this tax change on premiums of large accounts, even if passed through dollar for dollar (it won't likely be -- see discussion of ratemaking below), the impact is only 0.6%. /5 This is a minor part of the total costs of doing business, and competition is much more related to such items as the cost of selling, overhead and so on.

More importantly, the laws of most states require that the insured demonstrate that it is unable to purchase insurance from any domestic insurance company prior to approaching the non-admitted market. Although in practice states may not enforce that provision as effectively as they might, that is another problem of state regulation and not of tax code.

Regarding self-insurance and captives, the strong trend in that direction would not be significantly altered by this tax change. The problem with insurance vs. these alternatives is related to a fundamental insurance industry problem: inefficiency, not tax codes which actually favor insurers currently.

It is claimed that GAO's policy would lead to anti-consumer behavior to hold up claims to match the discount model.

The incentive to delay claims is related to the interest rate available, much more than tax policy. Taxing sooner, if anything, lessens the incentive to delay since, the faster the company pays this year, the shorter the discount period it uses next year and, thus, the less tax it pays up front. The incentive is de-minimus but actually favors faster payout, a pro-consumer factor.

Finally, commentators claimed a lack of GAO justification for collecting a heavier tax if the loss is reimbursed one year later than if it is reimbursed immediately. The following example shows that the GAO approach is correct:

> Assume that a policyholder, P, insures machinery with insurer, Y, for a premium of $100 and that a law suit served on P with a value and cost of $100 occurs. Absent insurance, P would not report $100 less taxable income as a result of the suit, i.e., would not have an immediate loss deduction of $100, but would only deduct it 10 years hence. However, since insurance has shifted the loss to Y, Y can reduce income immediately by $100, which it does by establishing a "loss reserve" of $100 and thus gains an immediate tax write-off. The consequence of the accident to the Treasury is [not] the same.

Discounting will reconcile the difference in tax treatment.

The fact is that, for liability cases particularly, the time between event and actual "loss" can be great, often running for a decade. Such "insurance" transactions as occured after the MGM fire in Las Vegas, so-called retroactive "insurance" (which is really not insurance at all, NICO doesn't believe, but a financing deal) is made possible by a combination of high interest rates and the failure of the tax code to discount reserves. Thus, while MGM would have had to carry the liability on its books for years, insurers could immediately write-off the undiscounted reserves, sold to them as a retroactive tax-shelter in a year of high investment profit. NICO has vigorously protested to IRS that retroactive insurance should not receive tax benefits. Our primary argument is that retroactive financing is not insurance at all and thus should not be deductible. It is clear that discounting as proposed by GAO would go a long way to eliminating this tax avoidance gimmick.

The major area of concern NICO has with the GAO Report is its apparent lack of understanding that most pricing of property/casualty insurance will not be impacted by this change in tax code.

For personal lines insurance, most insurance companies make rates using an approach in which federal taxes never come into play in the ratesetting process except to support the arbitrary 5% pre-tax underwriting profit via the use of such statements as, "How can we be excessively profitable when our pre-tax profit on sales is only 5%; after all, that's only 2.6% after taxes!"

There are exceptions. In about 20 states for private passenger auto insurance, some reflection of investment income is made. Even when this is done, in most cases federal tax policy does not come into play. It is not likely that this would change, because that would require discounting of reserves for ratemaking which would lower, not raise, rates.

In a few states, total return ratemaking is employed. There federal tax rates are used, but timing of actual payments is usually not used. The five models outlined in the NAIC report /6 are of interest. None of the models would vary the ultimate rate one cent based upon the GAO's proposed tax code amendments.

Thus, the impact on personal lines rates will be non-existent. One possible exception is State Farm, whose current total return ratemaking method looks at actual total return after tax rather than at a calculated figure, they might round up a point on occasion, impacting rates by 0.6%. This would be their judgment call (albeit their target return selected is already too high and their use of a contingency factor in the total return context is inappropriate) and is subject to state regulatory consideration.

In any event, the actual rate impact in personal lines will be next to nothing.

In commercial lines, the same is true for smaller, manually rated risks. Larger risks, however, are individually negotiated. It is doubtful that competition (especially from self-insurance) will allow much adjustment for this factor (the industry is already selling way below cost to these accounts -- although some firming up is in the wind without any tax change). It is difficult even to hazard a guess on the impact of this change, but 0.6% is the upper limit. Certainly, the total cost pass through of this change will not exceed 0.2% - 0.4% of premiums. When one considers this impact vis-a-vis the uncertainties of trending losses into the future nd how to reflect investment income in pricing, for example, it is lost in the static of actuarial judgments. In any event, the timing of this change, coming as it does essentially at the same time as the NAIC investment income change, means that many rates will be falling anyway for most small ratepayers who would be unable to pass through the cost.

It is clear to NICO that, rather than trying to pass this on (it would be too dangerous to do it since it begs the question of discounting reserves for ratemaking), the insurers will choose to manipulate investment portfolios, sell off bonds at losses, etc. to avoid this cost. GAO admits this effect is not in the Report tax revenue estimation.

The GAO Report shows a sound fundamental understanding of insurance principles, practices, accounting, etc. The approaches recommended are sound, feasible and necessary. NICO supports the GAO recommendations.

/1 Report of the Investment Income Task Force to the National Association of Insurance Commissioners, Adopted in Convention in June, 1984.

/2 Ibid, page 13.

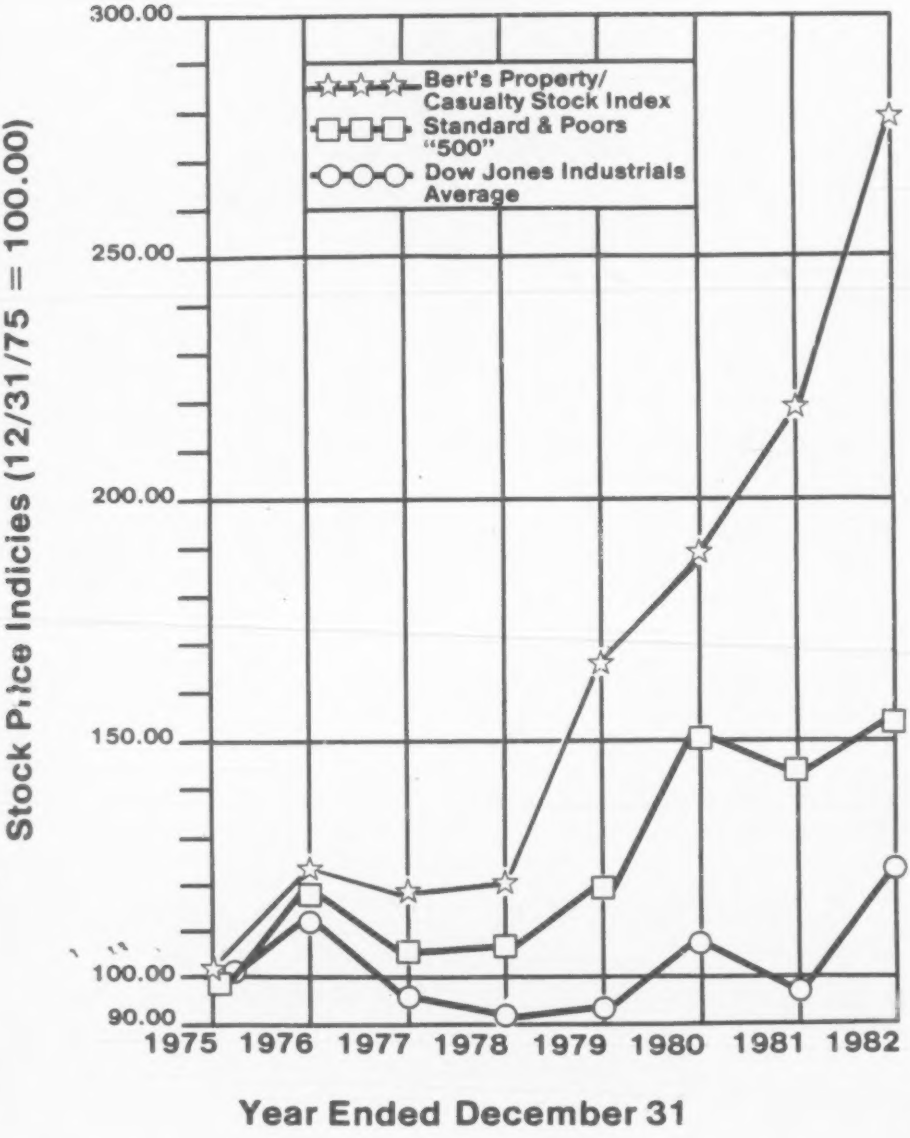
/3 See, for example, "Loss Portfolio Transfers," E.G. Jacob, Best's Insurance Management Reports, October 8, 1984. Mr. Jacob says, "I find the reluctance to discount loss reserves in financial statements somewhat illogical, since, on the asset side of the balance sheet, many companies include future interest income in the test of recoverability for deferred acquisition expenses. In my view, a loss portfolio transfer amounts to a selective reserve discount . . . ."

/4 Letter to GAO dated March 28, 1984.

/5 Assuming a 7% earning rate. The additional tax for 1982 of $613 million divided by the 1982 written premium of $102 billion equals 0.006.

/6 Op. Cit., pp. 49-80.

Stock Price Movements 1975-1982



Chairman **LaFalce**. Members of the panel, we will begin our questioning now. I think it's interesting that we are having a hearing today in the aftermath of a speech that President Reagan gave in Spain yesterday. I really think he let the cat out of the bag. All along he's been talking about tax reform and tax simplification, but when he spoke in Spain yesterday he said, what we need is a less progressive income tax in the United States. I hope everybody will see that that's really what this is all about more than anything else.

It's about a flat tax, a less progressive tax, or regressive tax, as opposed to the progressive tax we have had all along. That may be a sidelight, but I think it's interesting. It's a sidelight to the hearing, but I think it's central to the issue of the discussion of Treasury's tax proposal.

Having said that, I have always got a little bit of a problem the way individuals use words, and Congressmen right now are talking about freeze. Well, you know, I don't know what they mean. Moreover, they don't know what they mean or they mean 10 different things, depending on how they define it implicitly or not. Then they talk about cuts or increases—2-percent increase in Social Security, a 3-percent increase in the defense budget. Of course, in Social Security we're talking about nominal, and in defense we're talking about real. As I say, they are comparing apples and oranges. The 2-percent nominal is really a 2-percent cut with 4-percent inflation, and 3-percent real is really 7 percent.

To focus in on the insurance industry, I have heard so many individuals talk about the incentives in the Tax Code for the insurance industry, and I wonder if you could help me. What's the difference between an incentive and a subsidy? Mr. Hunter, what's the difference between a tax incentive and a subsidy for the insurance industry?

Mr. **Hunter**. It depends on if you're getting it or giving it, I guess. [Laugher.]

Chairman **LaFalce**. Would anybody want to comment on that? Can I scratch that and put in subsidy, or is there a difference?

Mr. **Jones**. I would think that there is a fundamental difference, but it probably depends on what you're trying to achieve. By tax incentive you seek to obtain a result.

Chairman **LaFalce**. For a subsidy, you don't seek to obtain a result?

Mr. **Jones**. Well, sometimes you use a subsidy to keep an operation in the market, for example, our merchant marine.

Chairman **LaFalce**. You don't do that with the Tax Code? You don't have tax provisions that do the same thing?

Mr. **Jones**. Well, it can operate indirectly.

Chairman **LaFalce**. I think you've got a hole in your boat on that one, Mr. Jones.

Mr. Schweiker or your assistant?

Ms. **Jenckes**. Linda Jenckes from the Health Insurance Association of America. I think I'd like to attempt to respond to your question by saying that the Tax Code is used for two purposes. It is either used to raise revenue which would be a subsidy, or it is used for good social policy—an incentive—and that's where I think the insurance mechanism comes into play.

Chairman **LaFalce**. Raising revenue is not a good social policy?

Ms. **Jenckes**. Mr. Chairman, you're right in one respect, but I think when you look particularly at the health side of the ledger you've got to look at the way the insurance mechanism comes into focus with the Tax Code. I think Congress over time has made a clear-cut decision that, rather than raise additional revenues to finance a national health insurance program, they prefer to give an incentive to the private sector to negate the need for the Federal Government to get involved.

Chairman **LaFalce**. I guess beauty is in the eye of the beholder. I would call incentive something hidden and a subsidy is something out in the open. So I'll say you're getting something hidden and some other people are getting something that's out in the open. I would say that something that's hidden is very often not understood by the public. If something is out in the open, at least you can have a chance for much greater accountability, also I think much more targetability. But we'll get into that a little bit later.

Mr. Hunter, you, unfortunately, were in Africa and didn't have time to prepare written statements regarding the life insurance industry, but surely you must have some thoughts about it because you're going to submit your written testimony in a week or so.

What do you think of Mr. Schweiker's statement when he said, if they want to tax the income buildup, the increase in cash value of your policy, that's the same thing as taxing the increased but unrealized value of a home, that is, appreciated property. Now what do you think of that premise?

Mr. **Hunter**. We have heard the home-insurance analogy for years. I don't ever believe it's been valid. It certainly isn't valid to say your whole life is like buying a house.

Chairman **LaFalce**. Can you document very well the appreciation in real estate, a home?

Mr. **Hunter**. You can actually count the dollars in your cash value.

Chairman **LaFalce**. So one difference is the precision with which you can tell it, the ease with which you can identify the buildup. In a home it's very uncertain. Insofar as an income buildup in insurance, it's very precise to the penny, isn't it?

Mr. **Hunter**. Yes, and I know I've sold a couple homes that I thought were worth more than I got for them.

Chairman **LaFalce**. And you make money on the buildup, too. You don't just make money on the principal.

Mr. **Hunter**. That's right. The buildup is invested. I think what we will probably say is that there are a couple of abuses. One is that there is an incentive or subsidy to the more wealthy in the society; the inside buildup seems to give a tremendous tax leverage advantage to the higher cash value policies, and the greatest tax breaks go to those.

Another thing is there are, as mentioned on page 263 of the report by the Treasury Department, there are some very abusive "borrow-to-buy" schemes that we will condemn in our statement I'm sure.

Chairman **LaFalce**. All right. Mr. Jones, you said the Treasury Department proposal really wasn't going to simplify things. In fact, could even make it a bit more complex. We haven't gotten into the issue of indexing interest. I don't know how that's going to simplify things, but could you amplify your statement? How do you think that the Treasury tax proposals in toto, not just with respect to the insurance industry, might bring about more complex tax forms than more simplified?

Mr. JONES. The qualified reserve account—and we understood that this hearing was to be directed at the Treasury proposal and not the GAO——

Chairman LAFALCE. Correct.

Mr. JONES. I think the older statement that Mr. Hunter had mixed them in and they are quite different.

Chairman LAFALCE. Well, we didn't preclude anybody from commenting on other issues.

Mr. JONES. But the qualified reserve account is a very artificial thing. When they propose that when you set up——

Chairman LAFALCE. Isn't the reserve account a very artificial thing too?

Mr. JONES. It's a very subjective thing, very subjective because you have to estimate——

Chairman LAFALCE. Especially when you set aside reserves that are incurred and not reported. I imagine it's really subjective.

Mr. JONES. It's subjective but there's some historical background on which you can apply your subjectivity.

Chairman LAFALCE. If you want to. If you don't want to, you don't have to.

Mr. JONES. It's a very difficult explanation we've had to make in any forum. But there, when we set aside this reserve, they propose that we artificially determine what income we think we're going to make in the future and take that away and then we can't add anything—we can't take any more deduction unless we adjust our reserve under certain conditions until we pay the claim. Then they have an artificial limit, they must mean, because they couldn't mean as they would in a life policy that you can't reserve more than the premium on that policy. They couldn't mean that, so they must mean our total premium.

Chairman LAFALCE. Mr. Hunter, that seems so complex, it really does. We wouldn't want to burden the insurance industry with such complexities. Wouldn't it be better to just tax all earnings on reserves, rather than have some discount?

Mr. JONES. The reason I raised the GAO approach is that I think the GAO approach is very straightforward and wouldn't require significant new accounting methods and accomplishes essentially the same result; that is, it takes care of the over-reserving due to the time value of money that is a current deduction.

Chairman LAFALCE. I'm wondering if there's really any way to deal with the problem of reserves since it is so subjective. The IRS, to my knowledge, right now has virtually no effective monitoring of your reserve practices.

Mr. JONES. Yes, they do. They use a number of techniques. They have been trying to develop one technique and they're still studying that and we are filing statements back and forth examining the way they are trying to do it, but they do monitor reserves. There's no question about it.

Chairman LaFalce. We called in the IRS from Connecticut a number of years back; I was very dissatisfied, and they were very dissatisfied with their ability to monitor your reserves at that time. Now perhaps there have been some improvements that have been made in their monitoring devices, but as far as I was concerned at that time you could get away with murder, and they wouldn't even know about it.

Mr. Jones. I don't think that's true.

Ms. Walters. Mr. Chairman, if I could, let me jump in here.

Chairman LaFalce. Bring me up to date.

Ms. Walters. On the question of not necessarily the IRS's capability but on the whole question of complexity revolving around property/casualty loss reserves, you are correct and Mr. Jones is correct that this is an incredibly complex process. In fact, the QRA proposal from Treasury I would submit is a totally unworkable process because it is so complex. Even Bob Hunter today has testified and GAO has found that Treasury's proposal would just add increasing complexity.

Chairman LaFalce. Isn't it hard to make an argument when you cite Bob Hunter on your side?

Ms. Walters. I never thought the day would happen. It's probably the only time in history. But to say that reserving is complex and that the IRS has difficulty in dealing with it doesn't mean it's a problem that's going to go away. This is how compatriots of ours, Bob's and mine—we're both fellows of the Casualty Actuarial Society—this is how many of our colleagues make their living. It is subjective. It's very difficult. It's very complex, but it's something that is at the heart of the insurance business.

Treasury's proposals dealing with qualified loss reserve accounts is simplistic when you're talking about one policyholder, one premium amount, and one claim. When one tries to interpret this for multiline insurers, dealing with 20 or 30 lines of insurance, it becomes almost impossible to figure out what they're talking about.

For example, are they talking about individual insurance lines as in the annual statement? In that case, you might, for example, deal with professional liability or medical malpractice, which is a separate line. But yet under medical malpractice you have hospital professional liability, physicians and surgeons professional liability. Some of those are written on a claims made form. Some of them are written on the occurrence form. You clearly can't have the same QRA for an occurrence form and a claims made form.

What about commercial accounts which may be composite rated or loss rated or individual risk rated? How do you set up a QRA for that? They said set up a QRA under a policy year basis, but the annual statement accounting is on a calendar year. If you set it up on a policy year, I would submit what you ultimately are telling insurers is you must have a separate QRA for every single account that you insure. That's absolutely and totally unworkable. And if the IRS today—and they do admit they have difficulty in auditing loss reserves because I would submit it's very difficult for an auditor to perform the same functions that a casualty actuary would perform with the same degree of understanding and the same professional capabilities—they are having difficulty today under a complex or difficult process. What would they possibly do with

QRA accounts? I think they would throw up their hands and give up.

Mr. Jones. Mr. LaFalce, I would like to say again that we never hear of overreserving. I know of no cases of overreserving. They are all underreserving. So I'm puzzled by all this.

Chairman LaFalce. Mr. Hunter is nodding in the negative.

Mr. Hunter. It depends on how you define it. For example, if I set up a reserve for $9,000 for a claim that I ultimately pay $10,000 10 years from now, sure, you could say I underreserved. But the point is, by the time 10 years rolls around I will have way more than $10,000 on that $9,000 due to the interest buildup. So it requires careful definition as to what you mean by overreserve and underreserve. When you count the interest buildup, their reserves are more than adequate.

Ms. Walters. I would have to jump in here again, Mr. Chairman, and say we are not talking——

Chairman LaFalce. God save us from a debate between two actuaries. [Laughter.]

Ms. Walters. When one looks, for example, as Bob did in his statement when he said the property/casualty insurance industry says they are suffering very bad times but, gee, just look at the stock market index for the last 3 years and it's going up, so it couldn't be all that bad. We're talking about—if that's the simplistic analysis that you want to accept, then you will accept his conclusion.

However, when you look at this industry which has suffered a $21 billion underwriting loss and total investment income was barely over $17 billion, you're seeing an industry that has a net operating loss of $3.8 billion for this year. You're seeing an industry on the whole that lost——

Chairman LaFalce. Let's not get into a definition of losses again.

Ms. Walters. These are real losses. This is something that has never happened before in this business. You can't look at a stock market index for 3 years and say this is not a bad time.

Chairman LaFalce. OK. But whenever I hear somebody from the insurance industry talk about an underwriting loss I immediately suspect——

Ms. Walters. No, no. I mean operating losses that include all investment income.

Chairman LaFalce. Very interesting.

Mr. Shumway.

Mr. Shumway. Thank you, Mr. Chairman.

Since this has evolved into somewhat of a debate of 1 versus 5, albeit Mr. Hunter has had a little extra time, I know Mr. Schweiker is anxious to respond to some of Mr. Hunter's remarks, and, for that reason, I will be happy to yield 2 or 3 minutes of my time to you, Mr. Schweiker, if you would like to respond.

Mr. Schweiker. Thank you, Mr. Congressman. I certainly would like to respond to remarks about favoring the wealthy. I think there are some real statistics that we seem to forget.

First of all, there are 153 million policyholders in the country. I don't think we have that many wealthy, affluent Americans by anyone's definition, and just, for example, the latest year we have figures on, 1983, we paid out $7 billion in death benefits, 63 percent of that payout went to wives and children, and two out of every three death payments went to people with less than $25,000 worth of income. Two-thirds of the payouts go to less than $25,000 income people.

Chairman LaFalce. What percentage of the payout, though, as opposed to the percentage of the people?

Mr. Schweiker. Well, two-thirds went to——

Chairman LaFalce. No, no. You're talking about the number of people and I'm talking about the total number of dollars.

Mr. Schweiker. Well, we'll be glad to get those for you.

Chairman LaFalce. Please.

Mr. Schweiker. Because I think they are relevant, but let me give you another figure that I think reinforces this. In terms of the amount that was purchased in terms of 66 percent of the permanent life insurance policies purchased were on lives of individuals with incomes of under $25,000. So even today people buying it, two-thirds of the people buying it—not getting benefit—are under $25,000.

Chairman LaFalce. Of the total amount of insurance that's purchased, do you have a breakdown according to income on that basis, as opposed to purely the number of policyholders?

Mr. Schweiker. We will get that, but again——

Chairman LaFalce. It's relevant to what we're talking about, the issue that Mr. Hunter raised, it seems to me. Would you agree, Mr. Hunter?

Mr. Hunter. Well, I rush to defend myself. I am for incentives, quote unquote, for the poor, by doing things for their savings. My argument is that the incentive is greater for the rich, and I think it's clear in the studies that are before you from Treasury and we will be sending some more statistics to you to back that up.

Mr. Minck. I think that if you'll look at our full statement you have some indications, but we will get some figures for you. We have looked at the frequency with which people in various income classes own things.

Chairman LaFalce. What is your name?

Mr. Minck. I'm sorry. Richard Minck from the ACLI. I'm with Mr. Schweiker.

Our prepared statement analyzes the concentration of ownership within various income classes; and you find the distribution is about the same among the lower income classes as among the upper for things like savings accounts, and life insurance policies. Tax-free municipal bonds, stocks, and other investments are concentrated very heavily among the upper income brackets, but we will get you the numbers, and they will show you the distributions.

Mr. Schweiker. I don't think you will see too much difference in that pattern, but I think you're right in asking for the numbers and we will get them.

[At the request of Chairman LaFalce for additional information, the following letter dated May 8, 1985, was received from Mr. Schweiker:]

American Council of Life Insurance

1850 K Street, N.W.
Washington, D.C. 20006-2284
(202) 862-4300

Richard S. Schweiker
President

May 8, 1985

The Honorable John J. LaFalce
Chairman
Subcommittee on Economic Stabilization
U.S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Thanks again for your courtesy at the hearing held this morning of the Subcommittee on Economic Stabilization. We very much appreciated the opportunity to discuss our concerns about the Treasury Department's tax proposals on our customers and on the life insurance business.

One question that you raised and that we promised to answer concerned the distribution among households by amount of death benefit (rather than by number of policies) of individual life insurance that would be affected by the tax on the "inside build-up" proposed by Treasury. To respond to that question, we have tabulated results from a national survey conducted in 1984 for the Life Insurance Marketing and Research Association and the American Council of Life Insurance. The survey (not yet published) provides an inventory of whole life insurance coverage of households in the United States. The average amounts of whole life insurance by household income class were applied to census bureau data to determine the aggregate amount of life insurance in force by income class. The results are shown in the attached Table I.

Once again, we appreciate your concern and those of the members of the Subcommittee about the consequences of the tax changes proposed by the Treasury.

With best wishes,

Sincerely,

Dick Schweiker

Richard S. Schweiker

Enclosure

TABLE I

DISTRIBUTION OF AMOUNTS OF WHOLE LIFE INSURANCE COVERAGE OF HOUSEHOLDS IN THE UNITED STATES IN 1984

Annual Income per Household	Whole Life Insurance Owned by Households	Percentage of Total Owned by Households	Cumulative Percentage
$20,000 or less	$ 320 billion	27.8%	27.8%
20,000 - 30,000	260 billion	22.6	50.4
30,000 - 50,000	340 billion	29.6	80.0
50,000 - 75,000	130 billion	11.3	91.3
Over $75,000	100 billion	8.7	100
TOTAL All Households	$1,150 billion	100%	

Source: National survey done in 1984 for Life Insurance Marketing and Research Association and American Council of Life Insurance

Mr. SCHWEIKER. I would like to just respond to one further point to Congressman Shumway, and that is that we figured what the average person would be hit in terms of taxes under this proposal, and we used very conservative assumptions. We will be glad to repeat those assumptions.

But basically, the lifetime tax on a person under the Treasury I proposal would be $22,800 on group health for the average worker, inside buildup of about $5,800, and the group life about $4,300. So this isn't taxing the rich fat cat in terms of what we're hitting. We're hitting the average worker today with about $32,900. Now that's a price they pay for apportioning more of the revenue across the board. I think it's interesting that in the survey I cited earlier that people don't think they should pay that price, and some of them even said they would pay a higher income tax rather than a tax on benefits. That's how strongly they feel about it, but they would be paying a tax in essence of cost to them of $32,900, and that's the average person. That's not the fat cat.

Mr. SHUMWAY. Thank you, Mr. Schweiker. I know we will be discussing some of those points further as the hearing progresses.

I'd like to change the subject a little bit. One of the concerns that I have if the Treasury plan does take effect is that perhaps there would be a serious dropoff in the provision of group term life insurance and I'm just wondering, do you have any facts or statistics available to you that would indicate that employers really would stop providing that kind of insurance if, indeed, the tax exclusion should be eliminated? Has there been any study made in that regard or have you heard from American businesses in that regard?

Mr. SCHWEIKER. I'll ask Mr. Minck, the executive vice president to respond.

Mr. MINCK. There are no formal studies that I know of. We have heard from American business, though. One point they make is that amounts in excess of $50,000 are already taxable income to the employee. The change in the Treasury proposal is to tax everybody starting from the first dollar. Now, that will increase the payroll taxes that employers will have to pay because that's going to be new income to the people who are under the Social Security wage base. It also will tax most employees for the first time. Most employees do not have group life term taxable amounts currently.

That means that many employees will be faced with the choice for the first time of whether or not they want to continue to take this coverage from their employer. Up to this point in time it hasn't cost them anything in taxes so it has been a complete plus, but there are employees who have no immediate needs for life insurance or who feel that their needs for cash are a lot more pressing than their needs for group insurance.

Mr. SHUMWAY. Again, you don't have any studies or accurate figures?

Mr. MINCK. We don't have any study because I think until it happens it's hard to get reliable information on what people will do.

Mr. SHUMWAY. Do you have any information at all on the question of how large that tax exclusion is on the average to a company? I'm sure it depends on the size of the company, but is there an average figure?

Mr. MINCK. Again, the tax wouldn't apply to a company per se except for Social Security taxes on the new income base. For the employee who would have the tax to pay, it would depend on his age as well as the amount of insurance. The amount of insurance would not be more than $50,000 that would be taxable for the first time and at ages, the current rate at middle age is a dollar something a thousand a month. So you're talking about perhaps $1,200 of taxable income that an individual would have.

Mr. SHUMWAY. Just one other question. As I understand it, the rationale put forward by the Treasury in defense of this proposal is that the lower tax rates and the increase in the personal exemption would offset the elimination of these deductions. Do you think that is a quid pro quo? Is there validity to that rationale or not?

Mr. MINCK. Well, I think our feeling—and Mr. Schweiker may correct me on this one, but we don't see that the two are necessarily connected. For example, the proposal to change the tax treatment of individual life insurance would not generate more income, since they would also allow you to deduct the premiums that you're paying as a contribution to an IRA. In fact, the total proposal would reduce revenue. So we don't think you need to have that proposal in in order to lower the tax rates.

The question of where any individual falls of course will depend upon what tax bracket he's in and how many things he's going to have taxed for the first time.

Chairman LAFALCE. Let's revisit that again now. Let's make sure that we all understand what is in Treasury I and would you repeat what they would permit you to do insofar as the deductibility of the premium is concerned?

Mr. MINCK. Treasury I's proposal, Mr. Chairman, is that first of all you would have taxable something they call the inside interest buildup and what that is——

Chairman LAFALCE. Why are we interested in that?

Mr. MINCK. Well, I think to explain what they let you deduct. I need to go through it.

Chairman LAFALCE. All right. Go ahead.

Mr. MINCK. You would have to add to your taxable income each year any dividends from the company, the increase in cash value for the year and something they call a cost of term insurance protection under the contract. You could deduct the premium you pay for a policy.

Now what they say is that this taxable amount you could put into an IRA if you wanted to and if you had room under the IRA limits. In addition, if you took out a new policy, you could put the premium for the policy in the IRA, and the inside buildup would be sheltered under the existing IRA rules.

They also would grandfather existing contracts. So for the first 5 years there would be no new tax on existing contracts, and on all new contracts you could put the premium into an IRA account and take a deduction from your net income.

When you net those two things together, we think they would lose about $1 billion a year in tax base.

Mr. SHUMWAY. Whereas Treasury is claiming that's revenue neutral?

Mr. MINCK. Their claim is they would gain about $4 billion a year on the inside buildup because they neglected to take into account the fact that they are grandfathering existing contracts and, on the other hand, they buried the IRA part in the general IRA section so it doesn't show up anyplace as a separate item.

Mr. SHUMWAY. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Dreier.

Mr. MINCK. I think it must have been part of simplification, the idea of putting part of the inside buildup into IRA's.

Mr. JONES. I would like to add that's another example of nonsimplification.

Mr. DREIER. Thank you very much, Mr. Chairman.

Senator Schweiker, I would like to ask you to put on a hat that you used to wear. You know that tax reform is obviously an issue which is on the forefront and we, as Republicans, talked about it in the last campaign. Democrats have also raised the issue of tax reform. The American people want to see their very complex 1040 simplified.

If you were sitting today at the Cabinet table, what kind of discussion would you be participating in concerning the whole issue of tax reform?

Mr. SCHWEIKER. That's not as theoretical an exercise as you might suspect, Congressman.

Mr. DREIER. Do you still attend Cabinet meetings?

Mr. SCHWEIKER. No, but we did have this up for discussion while I was in the Cabinet. We had it up for discussion before the Economic Cabinet Council that I sat on, and we spent about a year discussing it. When I left we had decided to abandon the project on the basis that it was too complex, too complicated and too——

Mr. DREIER. The simplification was too complex?

Mr. SCHWEIKER. Absolutely, and we decided to abandon the whole project. So I guess I was a little bit surprised when I got in the private sector 12 months later and found it resurrected because the consensus of that group then was that it had too many pitfalls and too many problems.

Mr. DREIER. So you would argue that you should still be a member of the Cabinet?

Mr. SCHWEIKER. I guess I'm saying that I would make the argument then that I'm making now. I think a good illustration is just what we saw here. To figure out what—there are 150 million policyholders—to figure out what they owe the Government you will have to find out what dividend they got from the policy, how much premium they paid, then you're going to have to know what their cash value went up that year——

Chairman LAFALCE. Is that difficult—the dividend, the premium, the cash value? Isn't that something that you have with precision?

Mr. SCHWEIKER. And the annual removable term rate for your age bracket, and you're going to have to do it 150 million times, and you were given a W–15 withholding form, and you're going to say to a policyholder you owe $1,000. What American is going to believe that he owes $1,000? You will need an actuary, an accountant and a lawyer to figure you owe $1,000 because you'll think you're getting taken, and then you're going to audit him on that $1,000. Now I can't believe that's tax simplification, Mr. Chairman. That's the thing we ran into in the Cabinet.

Mr. **Dreier**. Did you raise that argument at that point when you were at the Cabinet table?

Mr. **Schweiker**. I didn't know enough then to argue that way.

Mr. **Dreier**. One of the big issues which is constantly confronting us as members of the full Banking Committee is to try to create a level playing field for the delivery of financial services, and the question that is so often raised with universal life is, what is the difference between those kind of policies and regular investments. How would any of you on the panel respond to the question of should they be taxed differently?

Mr. **Schweiker**. Well, I think let me respond in a couple of ways. First of all, I think this level playing field is very interesting because the first thing Treasury says is, "Aha, you life insurance people are an investment product so we ought to approach it as an investment product to make it a level playing field." My response to Secretary Regan was if we are, why don't we tax the stockholder on the annual increase of the value of his stockholding or his bond? What kind of a level playing field is that? We would not be taxed as other investment products are. They would be favored and we would be discriminated against because the stockholder and the bondholder doesn't have to pay a tax on an increase until he sells his asset. So that's really not level playing field.

Chairman **LaFalce**. Is one permanent and the other temporary? In other words, if your stock increases, isn't that possibly ephemeral but isn't the increase in the cash value of your policy permanent? It's not going to go down.

Mr. **Schweiker**. Well, they're increases in your asset and you still——

Chairman **LaFalce**. But these are totally different types of increases, aren't they?

Mr. **Schweiker**. Well, if you sell them they're not.

Mr. **Dreier**. That gets back to the same home question that was raised earlier.

Chairman **LaFalce**. Yes.

Mr. **Schweiker**. And the other part I want to answer on the level playing field is that you have a Federal Deposit Insurance Corporation which obviously has Federal support and Federal backing and access at the Fed window. We don't have the benefit of those emollients as well, so we don't think it is a level playing field.

Mr. **Dreier**. The concept of savings—excuse me, go ahead.

Mr. **Minck**. I was going to add, and this is just an aside, some policies with cash values have cash values that go up and then come down term to 65, for example. It's not fundamental to our argument, but there are some that go that way, but our basic thrust I think is that a cash value is a different sort of animal from the savings account in that what you get—the way you get a cash value and realize it is through the surrender of the contract. People who pay their premiums and keep their life insurance policy in force until they die never realize the cash value. The present tax code is to tax you when in fact that value is realized if you do cash in the policy. If you don't cash in the policy, you're not taxed. The same thing is true of the treatment of annuities. You have built up in cash values for annuity contracts during the period before payments start. Once payment starts, there are no more cash values. That's another important area where cash values disappear, and what you get depends on how long you live. So again the current tax treatment is to tax you on the money when you actually receive it, and we think that is a sensible thing to do. We think that the savings account is a different type of animal and that different tax treatment is appropriate.

The other point I think is there are a number of other things you can't do with life insurance policies for tax purposes that you do for savings accounts such as the IRA.

Mr. **DREIER**. That's what I was going to ask you. What about the question of the individual retirement account and how does it compare?

Chairman **LAFALCE**. Let me just follow up on that. Doesn't treating it the way Treasury wanted to treat it give the authority as to what to do with that interest income to the holder of the IRA account as opposed to the insurance industry? Isn't that one of the primary reasons you're opposed to it?

Mr. **MINCK**. Again, the holder of the IRA account can't take the money out without penalties and can't take it out without surrendering the contract. I don't think there's any authority that would be given to him by allowing him to fund an IRA through an individual life insurance contract and as for the question of level playing field, the IRA deduction——

Chairman **LAFALCE**. The issue is not taking it out. The issue is control of it short of taking it out.

Mr. **MINCK**. If you can't take it out, I don't know——

Chairman **LAFALCE**. You can determine how it's going to be invested and how it's going to be used.

Mr. **MINCK**. Not with a life insurance policy. If you're using a life insurance policy to fund an IRA, it's still a life insurance policy.

Chairman **LAFALCE**. So you still wouldn't be able to control it.

Mr. **DREIER**. May I ask just one final question. Senator Schweiker, in your testimony you mentioned the fact that under last year's deficit reduction plan changes were made with respect to insurance taxation and you said for that reason we shouldn't be making further changes or something to that effect.

I wonder what aspects of that deficit reduction package which I incidentally voted against last year—it was misnamed the deficit reduction package as far as I was concerned—but what aspects of that package would you favor modifying?

Mr. **SCHWEIKER**. Well, first, let me respond to one part that I think is relevant. In that package last year we had worked with the Treasury in working out a new revised definition of life insurance to get to the issue that they are now readdressing, and I have a very nice statement from Assistant Secretary Chapoton saying that the way that they worked it out and the resolution they made was in fact a good basis for proceeding in the future in terms of fair treatment and evenhanded treatment on the matter of investment versus a protection policy.

So we do have from the Treasury last year a feeling that Congress had done that. We are a little bit hard put to come back and be asked to do the same thing the second time.

In terms of your question itself, we really feel that after a very difficult resolution of issues between stock and mutual company taxation, which is not easy, as well as consideration to balance it in a way that's fair and evenhanded and put a fair proportion of income in the coffers of the Treasury, that we ought to give it a chance to work before we rewrite the tax law.

When I was a Congressman or a Senator, we never rewrote the tax law for an industry 2 years in a row or 3 years in a row. What kind of expectancy, what kind of business anticipation, what kind of economic growth will we have if we're going to rewrite everybody's Tax Code every year or two? And I guess our gripe here is, having tried to have some new ground rules and fairness, that to go and review it, nobody can plan or grow or even think in terms of what we're doing.

Mr. DREIER. So you just argued again for the fact that you should be on the cabinet because when you left you thought the whole question of the modification of the Tax Code was a closed subject.

Mr. SCHWEIKER. Well, I thought it was, but it obviously got resurrected that's for sure.

Mr. DREIER. Thank you very much, Senator. Thank you, Mr. Chairman.

Chairman LAFALCE. I'm trying to proceed in the order that members came. I would call on Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman. We are very fortunate that the Speaker has given us some additional time. We were supposed to go in at 11 o'clock and I'm supposed to be over there. I appreciate the Speaker's consideration for our committee meeting.

I found it kind of interesting today that we are talking about something—and Mr. Schweiker brought it up and it's been referred to on a number of occasions—as a safety net. Having been an employer in the private sector and responsible in the public sector at a lower level for over 7,000 employees, I would like to point out for the record that one of the best things that ever happened to the entry level of lower income employees is a group insurance policy that provides survivors with the necessary resources by which to continue the life cycle until such time as adjustments can be made, including the payments on the house and the payments on the car and buying of food and so forth.

In my opinion, based upon my observations over those years, if that were to become a taxable type of benefit, there would be a reduction in the number of plans offered, resulting in much more of an impact on the entry of lower income levels than one might think, which for the benefit of those who are advocating this, would automatically manifest itself into additional costs for welfare payments—in our case, MediCal for indigents in California, which in my opinion would far overshadow the savings.

Now having said that and risking that I am an advocate for the insurance companies, I would like to get into what Mr. Jones talked about, the payout versus income ratio and the losses that have been sustained by the industry as a whole.

I would suggest that possibly we are looking at the insurance companies today and their losses in maybe somewhat of a light of that of the savings and loans and the banks. I personally observe some very poor investments on the part of insurance companies, particularly in the field of real estate development where they have achieved substantial losses by participating in these things, some of which I consider nontraditional for this type of institution.

Sure, you can point to one where you made a lot of money for your company, but I can also point to two or three where you took a substantial loss.

I'd like a comment from you, Mr. Jones, on how satisfied you are with the investment portfolios as they now exist with respect to the insurance companies that you alluded to.

Mr. **Jones**. I think overall those investment portfolios are quite sound. We are a very large supplier of the municipal bond market. We are strongly into equity securities. You do point out that there have been some companies that went into real estate and did it poorly, but I think you will find that generally that is not a typical example of the investment portfolios of the companies.

On the other hand, the insolvencies we have had have normally been coming from the loss side, not the investment side, and from poor management in the underwriting of their fundamental business and always underreserving. When a company goes into insolvency in almost every case we found substantial underreserving.

Ms. **Walters**. I'd like to follow up, Mr. McCandless, if I could. In the property/casualty area, there is a great deal of regulation of the types of investments that property/casualty insurers are permitted. As a practical matter, the current condition of the industry in this cycle is quite different from previous cycles for the very reason that the depletion——

Mr. **McCandless**. If I could make a clarifying point, we have gone from accident health to casualty, if I understand correctly, which are two different ballgames. Are you saying the same regulations apply?

Ms. **Walters**. No, sir; they do not. There are different regulations which apply to life and health insurers.

Mr. **McCandless**. The question you're responding to, are we talking about state regulations?

Ms. **Walters**. Yes, that's correct. In the property/casualty area, the depletion of surplus came about not because of investment losses or even capital losses. That is, they didn't come about through stock market decline or because of investment problems.

The losses came about because of a decline in operating income which means when you look at the underwriting side, that is, the insurance companies who are in the business of providing insurance lost so much money on insurance that even though they made a significant amount on investment income it was not able to overcome the underwriting losses. It was the pricing problem brought about by heavy competition which resulted in almost $4 billion of pretax operating loss which finally translated itself into a depletion of surplus. It was not on the property/casualty side an investment problem at all.

Mr. **McCandless**. I don't know how much time I have. May I ask another question?

Chairman **LaFalce**. Sure.

Mr. **McCandless**. Given this scenario that you have just painted, how does the sales curve—what does it show at the same time? Is there a declining sales curve in this kind of a situation? Are you a level curve or are you increasing your sales to bring in additional revenue?

Ms. **Walters**. Well, part of the problem throughout calendar year 1984 was a great deal of the industry for about three or four successive quarters was in fact operating at a negative cash flow. So it's not in very good condition when you're losing money on every dollar you write. In the fourth quarter of 1984 and the first quarter of 1985, our industry has seen very substantial premium increases correcting what we believe has been the overriding problem—excessive competition leading to inadequate prices. That is starting to be corrected now.

However, because of the depleted surplus, the industry is in a very tough position. They do not have enough surplus available to write all the business that's out there. There just isn't enough surplus. So they are trying to write more business which we hope eventually will make a contribution to surplus through positive operating income, but we don't see that happening for possibly 2 more years.

Mr. **McCandless**. I see the subject somewhat clouded here.

Ms. **Walters**. It is very complicated.

Mr. **McCandless**. Maybe I can shed some light on it. If I take out an insurance policy for a given amount for purposes of our discussion, $10,000 in 1950, and I'm paying at the rate of so much per month, the loss that eventually will be incurred by that insurance company 30 years later or 10 years later, whatever the term may be, is still going to be the $10,000.

Ms. **Walters**. No, Mr. McCandless. Are you talking property-casualty insurance or are you talking life and health insurance?

Mr. **McCandless**. Straight life.

Ms. **Walters**. Then you're getting the wrong answers to your questions. I'm responding from the property/casualty insurance industry perspective.

Mr. **McCandless**. I'm asking the panel and you bounced back and forth between casualty and life, and I didn't know.

In the meantime, though, the benefit of that straight life policy with respect to what it offers in the way of investment potential, has substantially increased to the point that at one time in recent history it would bring 20 percent instead of maybe the 5 or 6 percent at the time the policy was taken out, given the straight life situation.

Yet, we are incurring losses here, and you have the benefit of a fixed payout based upon that kind of insurance, which is a little confusing to me, how you find yourself in a bind when you've got that kind of a factor involved. I'm not talking about these appreciating annuities or those kind of things. Because there is a lot of straight life still written.

Ms. **Walters**. Mr. McCandless, I made that confusing by jumping in on Mr. Jones' question. Both Mr. Jones and I were referring to the property/casualty insurance business.

Mr. **Minck**. The life insurance business has not experienced the sort of adverse financial results that have been discussed, fortunately, and I think the question of the death benefit under a straight life policy over a period of time depends upon the type of contract. Typically, we sell either participating contracts with dividends going back to the policyholder that can be used to purchase additional insurance if the investment results change or contracts in which cash value is built up reflecting investment results. So if the periods are favorable, the investment experience that you're referring to are typically reflected in additional benefits being made available to the policyholder.

Chairman **LaFalce**. Thank you very much.

Mr. McMillan.

Mr. **McMillan**. Thank you very much, Mr. Chairman. I appreciate all of you coming in and testifying before our chairman and the Republican side of the committee.

Chairman **LaFalce**. Unfortunately, the Democrats are having a caucus right now about something called the budget.

Mr. **McMillan**. Well, I left the end of a conference to get here, Mr. Chairman.

One of the strongest arguments for considering tax reform, Mr. Schweiker, in my judgment, at this point is to try to avoid the very problem that you describe, and that is constantly changing the Tax Code so that it is very difficult for either the individual or the corporations to anticipate what Government is going to do. That may prove to be an impossible task, but I think that's certainly my point of departure in being at least at this point less than enthusiastic about considering it.

I have a couple of questions that fall into the personal benefit side. I think we talked a good bit about buildup in life insurance policies and I think philosophically it's very important for us to understand the difference between that form of savings, if you want to call it that, as opposed to other forms of savings that we are taking a lot of innovative action to encourage. For example, pension plans, contributions and deductions thereto, individual retirement accounts.

Would you comment just a little bit more on the philosophical similarities between cash buildup in life insurance as opposed to those other forms of savings? I realize the death benefit aspect of it, but I thought the statistics that you mentioned earlier about two-thirds of those benefits going out as at least on an individual basis as a death benefit, but I think it's also important to consider it as a form of savings or an alternative to pension plans and IRA's and so forth.

Mr. **Minck**. Mr. McMillan, the level premium life insurance policy that generates cash values and has the savings elements that you have been talking about was designed primarily to permit people to take coverage into the higher ages and still pay the same premium for it each year. It's a sort of savings in the sense that you will be prepaying some of the costs for coverage during the period of your lifetime when you retire. If you hadn't selected a level premium base for paying for it, the premium would have increased year by year as you grew older, then you would have much higher premiums to pay when you retire. So, in a sense it's providing for a necessity to cover you during the period after you retire and paying for it during the period that you're working, so there is, I think, a similarity in what's being aimed at and methods used for those in the pension plan area.

Mr. **McMillan**. Well, that would be my feeling. These other forms of future financial security, whether it's a pension plan or an IRA or an employees stock ownership plan for that matter, anticipate the same sort of future financial needs. Therefore the best argument for continuing to provide a tax incentive for cash value life insurance rests upon the similar assumptions that we used in supporting IRA's and pension plans and so forth. Would you agree with that?

Mr. **Schweiker**. I certainly would, Mr. Congressman.

Mr. **McMillan**. There was one other question that I had and it had to do with medical deductions by the corporation. I think one of the problems that we have to deal with is the equity between that benefit in contrast to the individual who has to pay their own medical premiums and often at much higher rates with less favorable tax treatment.

What would you suggest as a way to provide equity in that that would be an alternative to the Treasury's proposal?

Ms. **Venckes**. There are actually several bills that have been introduced to date that would give the individual the same financial protection and tax treatment, if you will, against medical loss and we would support something like that. Keep in mind that if you individually itemized your tax form, there was for years a separate deduction for health insurance you could take which Congress took away a couple years ago. We would strongly support that it is put back in.

Mr. **McMillan**. Well, that seems inconsistent with allowing deductions on the corporate side for medical plans. The other side is the relative cost to the individual trying to buy medical coverage which I think is really another issue that may not be a subject of this discussion.

Ms. **Jenckes**. That's one of the problems with the proposal in terms of the health community. We feel that if you do in fact impose this cap, the whole group mechanism will unravel. You will find out that, over time, more people will have to buy individual protection. The young, the healthy, will drop out of the group and eventually only the older workers or the sicker workers will be in the system. Over time, it will force more people to be uncovered through group insurance and, therefore, it sounds like an outlandish thing to say, but I think it will force the national health insurance issue all over again.

Chairman **LaFalce**. Isn't that a good argument for it?

Ms. **Jenckes**. Right now the insurance industry is doing everything we can to fill the gaps. There are many people right above the Medicaid level in the State of New York or in the State of California, for example, who are not covered by the MediCal or Medicaid programs who need health protection. We are also looking into state pools for the uninsurables. These are uninsured individuals that do not have the benefit of a group insurance mechanism and can't get individual coverage. Many are medically dependent on life saving mechanisms. Representatives Kennelly, Gradison, Matsui, and Holt have introduced that bill, H.R. 1770, and we are hoping to get it passed.

Mr. **McMillan**. If we took an alternative approach and tried to create an equal playing field—that is, allow the individual an equivalent deduction or benefit as they would receive if they were participating in a typical company operated plan, would it serve as a significant stimulus to address that need, in your judgment?

Ms. **Jenckes**. Absolutely.

Mr. **McMillan**. I have no further questions.

Chairman **LaFalce**. Thank you. We saved the best for last, Mr. Wortley.

Mr. **Wortley**. Just because I'm your neighbor. I commend you, Mr. Chairman, for holding these hearings and I certainly hope the slim attendance over here on the majority side is not indicative of the interest level.

Chairman **LaFalce**. Quality versus quantity, George.

Mr. **Wortley**. Well, Mr. Hunter, I must say that you completely shocked me this morning. I fail to see your distorted logic and maybe it's the jet lag or something, but when you are so critical of the insurance companies because they look attractive on the stock exchange——

Mr. **Hunter**. I wasn't critical. I wish I had invested in them.

Mr. **Wortley**. I'll tell you, I don't think you would feel a lot better if the insurance industry was a troubled industry like some areas of the financial services are today—thrift institutions and some others. I don't think it would benefit the consumer one single bit if you had a troubled insurance business and if I was an advocate of the consumer I would not be harping on that particular line.

I admire good management and I think we could use a lot of it starting right here in Washington, DC. I might go to Mr. Schweiker.

Chairman **LaFalce**. I think we need a response from Mr. Hunter as to whether he, in fact, did call for a troubled insurance industry.

Mr. **Wortley**. Could he do that on his time or your time?

Chairman **LaFalce**. You've just been given an additional 30 seconds, George.

Mr. **Hunter**. Of course I don't want a troubled insurance industry, but I was not the one who raised the troubled insurance industry issue. I responded to their chain of trouble.

Mr. **Wortley**. Thank you.

Mr. Schweiker, usually people go by the title of the most illustrious position they have achieved in public life. Do you prefer to be called Mr. President because you're president of the American Council of Life Insurance or do you prefer to be called Senator or Mr. Secretary?

Mr. **Schweiker**. Dick will do just fine.

Mr. **Wortley**. Or Representative?

Mr. **Schweiker**. I ought to be Representative over here.

Mr. **Wortley**. Some of us are very concerned about the capital formation because after all, it is the capital formation that constructs those buildings and buys new equipment and creates new jobs and makes American business competitive—competitive not only domestically but competitive in the world market. Capital formation drives the economy.

How large a role does the life insurance industry provide in fueling this economy in terms of overall sales and investments the life insurance industry makes?

Mr. SCHWEIKER. The life insurance industry has about $655 billion of these kind of investments, and in 1983 their purchases of this kind of investment was about $170 billion. Now some of that was turnover money. The new money going in through the life insurance industry through new jobs supplying and capital formation, there was about $39.4 billion of new money that year. Just to give you a little flavor, while we did rank fourth in overall supply of capital for the economy, on one key category of corporate bonds we ranked first. In fact, if you take commercial mortgages and corporate bonds together, we are still first.

So on what I would call the working capital for a lot of nuts and bolt jobs in the economy, we are really right out there. I think that's a very important aspect because if you get to just say taxing the inside buildup, for example, our rough calculations in that area showed that about $150 billion would be put at risk because it comes from that kind of investment.

Mr. WORTLEY. I don't think we should put that at risk. I'm sure you don't either.

Ms. Jenckes, I note in some of my statistics here that health insurance plans cost the Treasury about $29 billion in lost revenue. Pension plans cost about $78.8 billion. Life insurance costs about $3.1 billion. These are rather substantial figures of revenues lost from taxes.

If we were to recapture those revenues by eliminating the deductions, what negatives would you anticipate other than the possible creation of a national health insurance program which most of us don't want to see?

Ms. JENCKES. Quite a few, Mr. Wortley, and I'd like to perhaps submit for the record a study that we commissioned Price Waterhouse to do back in 1983. The proposal for a health care tax has been around for a long time. Actually, it started in the late 1970s, but this administration first proposed it in 1982. So we have been fighting the battle for a long time.

It was originally proposed as a cost containment measure. We don't feel it will work for that purpose nor do we feel it would work for the purpose of raising revenues.

What I would like to comment on is the Price Waterhouse estimates. At that time, the Treasury proposal on the health care cap was estimated to bring in approximately $26 billion over 5 years. The estimates today have increased to approximately $36 billion. When Price Waterhouse looked at it, they said that they felt that the estimates were overly optimistic in terms of people not switching to other benefits which are not taxable and in terms of again the young, healthy workers dropping out.

On the high side, the study basically said that it could raise—or you could get to $26 billion—by assuming a 12.6 annual growth rate with only 15 percent of the tax benefits going to nontaxable. On the low side, they said that it would increase, as opposed to the

$26 billion from Treasury, $6.5 billion over 5 years. The most likely, in their view, was perhaps $14.2 billion.

We disagree because we think approximately 50 percent of all employees would shift to other benefits.

I also would like to suggest that, in terms of raising revenues, if the advocates of the tax are correct, that if you impose a tax at a certain level or a cap at a certain level, it would make employees more aware of health costs. They would go to their employer and ask that their plan be limited to that $175 a month per family coverage and $70 for individual. If that in fact happened, there would be no revenue raised.

Now there are a host of other arguments and we have a paper that we would like to submit for the record that refutes all of the arguments made by Treasury or others to date. I think it covers it in terms of bad tax policy and bad social policy.

Mr. **Wortley**. Mr. Chairman, I ask unanimous consent that that be submitted for the record.

Chairman **LaFalce**. Without objection, so ordered.

[Submitted for inclusion in the record is the following material: "The Case Against the Taxation of Employee Health Benefits," a paper by J. Martin Dickler of the Health Insurance Association of America, and a Price Waterhouse study "Revenue Estimates for S. 640: The Health Cost Containment Tax Act of 1983." The material follows:]

THE CASE AGAINST
THE TAXATION OF
EMPLOYEE HEALTH BENEFITS

J. Martin Dickler

Health Insurance Association of America

March 14, 1985

THE HEALTH CARE TAX

The health insurance industry strongly opposes taxation of employee group health insurance plans. The following points illustrate why this proposal will not contain health care cost inflation and is an improper method for raising Federal revenue:

TAXING HEALTH BENEFITS IS BAD HEALTH POLICY

It dismantles the economic safety net provided to American workers by private enterprise -- Present tax policy has effectively replaced the need for a costly national health insurance program. The development of private employee group health insurance has opened channels of insurance to millions of workers regardless of age, sex, physical condition, or character of employment. In doing so, the contributions of employers and employees have drastically reduced pressure on charities, social, and governmental services in general and Medicare and Medicaid in particular.

For employee group insurance to work, essentially all employees in a group must be covered. But increase direct costs to the employee, through taxes or otherwise, and young, healthy and low-income workers drop out. As these workers leave the group, costs for older and less healthy workers go up in the form of higher premiums and out-of-pocket costs. And, as usual, it is the low-income worker who will be hit the hardest. In summary, take away favorable tax policy, and you move the burden from the private to the public sector.

It penalizes older workers -- Elderly groups tend to use health care more frequently than younger, healthier workers. Hence, the cost of health insurance for groups including more than the average number of older workers not only will be higher in price, but could discourage many employers from hiring older workers. This same principle may be applied to other high "risk" groups, including women and the disabled.

It penalizes those in hazardous, high-risk occupations -- Some groups, such as iron workers or coal miners, are usually considered a higher risk, and are typically charged higher health insurance premiums. These groups could be unfairly taxed while other groups with similar coverage, for example clerical workers, would be unaffected.

It could result in reduced coverage for preventive care services -- In trying to avoid taxation, rational consumers will not reduce expensive hospital coverage, but instead will eliminate cost-effective preventative services such as dental care, vision care, mental health benefits, and alcohol and drug abuse services. Taxing health benefits will do nothing to contain the driving force behind health care cost inflation, namely hospital costs, but instead may have a detrimental impact on consumers' health status.

TAXING HEALTH BENEFITS IS BAD TAX POLICY

It is a regressive tax -- A decrease in employer provided health benefits and the resultant increase in out-of-pocket health costs due to a health tax would hit hardest on those least able to afford it. In data presented to Congress in 1983, the Employee Benefit Research Institute (EBRI) stated that "as a proportion of income, persons at the lowest level of income (those reporting less than $10,000) would pay more than six times the amount of the tax than would persons with income over $50,000."

EBRI concluded that "...current tax policy probably raises private coverage rates significantly among lower-income worker households, households with fragmented employment histories, younger households, and both single-person and single-parent households." Taxing employee health plans could seriously undermine these successes.

It is a form of "double taxation" -- The Health Insurance Association of America estimates that Medicare and Medicaid payment practices resulted in $8.8 billion being shifted to patients covered by private health insurance in 1984 to make up for government underpayment to hospitals. For the government to shift these costs to the private sector and then put a tax on the resulting higher insurance premiums is patently unfair. Further, as pointed out above, it will be the sick and those most dependent on health insurance who will bear the burden of this cost-shift.

It unfairly affects certain geographic areas -- The cost of health care is higher in some areas, such as large metropolitan cities. A single national tax cap does not take geographic differences into account, and thus would particularly penalize those in high-cost areas. Conversely, it would allow the tax-free purchase of much more generous benefit plans by employers in low cost areas.

It would penalize employees of small businesses -- Small employers generally pay higher premiums than large employers for comparable plans. Hence, small employers would represent a disproportionate number of the employers affected by a health tax. Further, many small businesses have indicated that they would be forced to terminate their group health plans due to the increased administrative burden of adjusting payroll and benefit procedures to a health tax.

It would seriously curtail competition in the health care field -- The Reagan Administration champions the long-range effect of containing health care costs through increased competition in the marketplace. Ironically, a health tax could increase health care costs by thwarting competition. Cost effective alternative delivery systems, such as health maintenance organizations (HMOs), would be less attractive because they offer more comprehensive coverage at higher than average premiums.

Indeed, the Group Health Association of America, the national trade organization for HMOs, opposes the health tax proposal because it may do "lasting and irreparable damage to the ability of HMOs to compete in the market and therefore to their continued growth and development."

The Federal budget deficit should not be balanced on the backs of the sick and disabled. Present tax policy has fostered comprehensive private health coverage for the majority of working class Americans. The removal of favorable tax policy places this entire system in jeopardy.

I. Introduction

The taxation of employee health benefits is an issue currently receiving much attention in the Federal government. The November 1984 Treasury plan for tax reform includes a proposal to tax employer health contributions over specified amounts beginning in 1987. The Bradley-Gephardt tax reform proposal provides for the taxation of all such employer contributions. Various other legislators in Congress have stated their intent to reassess the current tax exempt status of employee benefits. Tax proposals of this kind are not new. The Reagan Administration has previously advocated the taxation of employer health contributions, and is clearly continuing its support of the idea. Opposition, however, has been widespread in the private sector.

The issues involved in taxing employee health plans are complex, and need to be thoroughly explored. The existing tax exclusion for such benefits exemplefies an enormously successful governmental health care policy. Today, as a result of that policy, most Americans enjoy health insurance protection through private sector employer based group plans. The removal of part or all of the tax exclusion will impair the ability of the private sector to protect employees through group insurance. The consequences of that can intensify pressure for expanded public insurance programs, despite the government's continuous struggle to control Medicare and Medicaid expenditures.

The arguments set forth by the proponents of health benefit taxation fall into three major areas, as follows:

- Tax Equity

It is claimed that the tax exempt status of employee health benefits favors high income employees, and that the tax preference is unfair to those without employer provided health benefits. In our view, the tax proposal will not result in greater equity among taxpayers. Instead, it will introduce much more inequity as compared to the present system.

- Revenue

Supporters maintain that the taxation of employee health benefits will curb the erosion of the tax base. There are those who see that as a way to raise additional revenue for deficit reduction, while others hope it will lead to reduced marginal tax rates. In our view, neither result is realistic as long as employers can implement tax avoidance arrangements. The only sure outcome is that the administrative burden on employers will be difficult and costly.

- Cost Containment

The advocates believe that taxing health benefits will result in greater health care cost containment. That view, however, is based upon implausible theoretical considerations and little in the way of cost containment can be expected from the tax.

The Congress should weigh carefully whether the taxation of employee health benefits will produce the claimed results, and whether it is wise to weaken our system of private health protection by imposing such a tax. In our view, few of the alleged benefits will materialize. We will have, instead, only more inequity among employees, frustration among employers, and the pressure for expansion of public insurance programs.

II. Tax Equity

A major objective of employee health benefit taxation is said to be greater equity among taxpayers. Critics of the current tax preference have noted that each dollar of tax free health benefits is worth more to a high income employee than to a lower paid worker. Others justify reducing the tax advantage on the basis that it is not available to workers without employer provided health benefits. Let us examine whether the proposal to tax employee health benefits will actually result in greater equity.

The Impact of the Proposed Tax on Employees

In order to see the equity aspects of health benefit taxation, we shall examine how the cost of group coverage will translate into taxable income under the November 1984 Treasury proposal. The annual cost of a group health insurance plan is determined by many factors. The most important are the coverages included, the age and sex composition of the group, the health status of the persons covered, the size of the group, the type of industry, and the geographical area of the country. We shall first consider the effect of medical cost levels in the area in which the firm is located.

A typical employee would be subject to very different amounts of taxable income depending upon where he lived. In Table A there is shown for each of ten cities, the estimated increase in 1987 taxable income for a male employee aged 40-44, under the proposed Treasury plan, assuming he represented the average for the group. The data are based upon the average of 1985 premium rates of five nationwide carriers, for a comprehensive medical expense plan.

Table A shows that the proposed tax will fall heaviest upon employees in the major cities of the nation, where medical costs are highest. If the employee worked for a 2-9 life group in Los Angeles, where the employer paid the full premium, his taxable income would rise by $1,193 if single, and $4,320 if also covered for dependents. If the same employee and firm were in Greenville, South Carolina, the taxable income would increase only $38 if single, and $616 if dependent coverage were included. A similar pattern occurs when a large group is involved, or when the employer pays only 75% of the cost of the plan. In low cost areas, the flat nationwide exemption amounts offset all or nearly all of the employer contribution to the group plan.

It is patently unfair to impose a tax structure that virtually exempts from taxation employees in low health care cost areas, but which heavily taxes workers in expensive urban areas. The Treasury plan is very inequitable for an employee in our largest cities, compared to an employee with the same annual income living where health costs are not high.

Table A also reveals the much higher taxable incomes that would result for employees of small firms, as contrasted to workers in large groups where premium rates reflect lower carrier expense levels. For example, an employee of a small business in Manhattan would have increased taxable income of $2,488 with family coverage and the employer paying the full premium. If that same employee worked for a large Manhattan firm of 500 employees, with the same non-contributory coverage, his taxable income would increase by only $1,393, which is 44% less. The extreme inequity among taxpayers by geographical area and size of group would be very distressing to many employees, especially those working for small firms in high cost cities.

TABLE A

Estimated Increase in 1987 Taxable Income
If Employer Contributions* Were Taxable
Above $70/Mo Individual, $175/Mo Family

City	2-9 Life Group		500 Life Group	
	Non-Contributory Plan	Employer Pays 75% of Cost of Plan	Non-Contributory Plan	Employer pays 75% of cost of Plan
Individual				
Los Angeles	$1193	$685	$528	$186
Miami	1009	547	473	145
Chicago	726	335	364	63
New York⁺	626	260	341	46
Dallas	458	134	82	-
Knoxville, Tn.	347	50	-	
Jackson, Ms.	254	-	-	-
Macon, Ga.	205	-	-	-
Fargo, N.D.	185	-	-	-
Greenville, SC	38	-	-	-
Family				
Los Angeles	$4320	$2715	$1946	$935
Miami	3674	2231	1791	818
Chicago	2822	1592	1454	566
New York⁺	2488	1341	1393	520
Dallas	1975	956	648	-
Knoxville, Tn	1575	656	339	-
Jackson, Ms.	1304	453	305	-
Macon, Ga.	1166	350	267	-
Fargo, N.D.	1088	291	135	-
Greenville, SC	616	-	-	-

⁺ Manhattan

* Based on a projection to 1987 of the average of 1985 premium rates of five nationwide carriers, for a comprehensive medical expense plan.

If we proceed one step further, to see how the Treasury tax proposal would affect high and low income employees, we uncover another gross injustice. In Table B, there is shown the total increased federal income and social security taxes that would be paid in 1985 in certain cities, if the Treasury proposal were already effective. The taxes are shown for an employee in two annual income categories, $15,000, and $35,000. It is evident from Table B that the employee earning $15,000 per year pays by far the largest percentage increase in tax. If he works for a small firm in Los Angeles, where the plan is non-contributory, his total federal income and social security tax would increase by $718 which is 36% more than his taxes under current law. These percentage increases are far greater than for higher income employees, which reveals the very regressive nature of the proposed tax. The $15,000 per year worker, on a percentage basis, will pay about twice more in taxes as the employee earning $35,000.

Since the increase in taxable income is the same for all employees regardless of cash earnings, lower income employees will be exposed to the higher percentage increase in tax in all groups where the exemption amounts are exceeded. Although the Treasury plan is intended to be revenue neutral in the aggregate, it is extremely questionable whether other reductions can be sufficiently fine tuned to avoid shifting an excessive tax burden to those who can least afford it.

Furthermore, the "revenue neutrality" of the Treasury plan applies only to the Federal income tax, but we must assume that the resulting increases in taxable income also will be subject both to Social Security taxes and those state income taxes which "piggy-back" the Federal income tax. These tax increases, which will not be off-set by the proposed Treasury rate Reductions, will also fall hardest on lower income employees.

The proponents of employee health benefit taxation have long argued that greater tax equity as between high and low income workers will result from this tax. It is true that under the current graduated income tax structure, a dollar of employer contributions to health insurance is more valuable to higher income employees. That, however, applies to all tax preferences such as interest paid, local taxes and charitable contributions. If that is a matter of inequity, then the progressive tax rate scale is to blame, not any one example of tax preference. Actually, as may be seen from Table B, when these employer contributions become taxable it is the lowest paid worker who is faced with the greatest proportional increase in federal income and social security taxes. It is difficult to understand the advocacy of this tax in the name of greater equity for low wage earners, when it is they who will be the most disadvantaged by its enactment.

There are many ways in which the Treasury proposed tax will create inequities other than through geographical area differences, size of group, and the regressive burden on low income workers. Let us see how they occur.

Table 8
Estimated Tax Increase If Employer Health
Contributions Were Taxable in 1985

		Annual Cash Wage			
		$15,000		$35,000	
City	Size of Group and Employer Contribution	Increase In Taxes*	% Increase	Increase In Taxes*	% Increase
Los Angeles	2-9 employees, employer pays all	$718	36%	$1,042	17%
	2-9 employees employer pays 75%	409	21	612	10
	500 employees employer pays all	267	14	407	7
Chicago	2-9 employees employer pays all	430	22	642	10
	2-9 employees employer pays 75%	204	10	312	5
	500 employees employer pays all	180	9	276	4
New York+	2-9 employees employer pays all	365	19	552	9
	2-9 employees employer pays 75%	161	8	246	4
	500 employees employer pays all	170	9	260	4

* Based on Federal Income and Social Security taxes for a family of four with no other income. In 1985, the total of such taxes are $1,971 for the $15,000 wage earner, and $6,256 for the $35,000 wage earner, excluding any tax on health benefits. Itemized deductions are assumed to be the greater of $3,540 and 23% of adjusted gross income. Increases in state income taxes not included.

+ Manhattan

Group health insurance is purchased by employers for the benefit of their employees, frequently with the advice of experts in the field. The employer usually decides upon the coverage to be provided, except when the insurance plan is the subject of collective bargaining. Normally, the cost of the plan is either borne entirely by the employer, or borne in large part by the employer with some employee contribution required.

If the employer's cost of the plan were to become taxable income to the employees, such cost would have to be allocated to each employee as imputed income, whether or not there is an exemption of some dollar amount. To be fair, each employee's imputed income should be based upon the actuarial value to him of the health insurance plan. Essentially, that means an annual determination of each employee's share of the employer's cost as a function of the principal actuarial factors of age, sex, coverage for dependents and place of residence. The extent to which this can be done on a reasonable basis depends upon premium rating practices and available data, which generally differ for small and large groups.

Let us first consider employees who work for firms with less than fifty employees. According to United States Department of Commerce data, there were 4.3 million firms with one to forty-nine employees in 1980. Based upon insurance company data, these small groups probably provide employment for over 15 million workers. There are many carriers active in the small group market and each offers a variety of plans for the employer to choose from.

A common characteristic of the plans sold to small employers is that schedules of age and sex specific premium rates are used, which are also adjusted for the locality in which the firm is located. The premium rates may also be adjusted to reflect the industry classification of the firm. With this kind of rate structure, there is a specific premium for each employee reflecting the actuarial rating elements of age, sex, dependents coverage, type of industry, and locality. Such premium rates reasonably represent the actuarial value of the plan to the employee, as calculated by the insurance company, and the employer's share of the premium could be readily used as imputed income. According to the November 1984 Treasury plan, however, the actuarial value of the health benefit plan will not be the basis for determining additional taxable income. The report states "The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees." Here we see another source of inequity for employees in small groups, where actuarial value is readily available from the age and sex distinct premiums paid by the employer. Take for example, a self-employed 55 year old accountant with a 20 year old secretary, who has purchased a small group plan. The premium for the accountant is much higher than that for the secretary, but the Treasury would give each employee imputed income equal to the average of their premiums. Clearly the secretary is subsidizing the accountant with respect to allocated imputed income. Speaking more generally, if each small group employee were assigned imputed income on the basis of an average premium, the young would subsidize the old and males would subsidize females. And, of course, there would still be wide differences in tax liability by area as shown in Table A.

Larger groups generally involve those with at least 50 employees, and can range up to the hundreds of thousands for the largest employers. For such groups, premium rating practices are quite different from those described for small groups. Employers with insured plans typically remit premium on the basis of monthly "billing" premiums, but the final cost depends upon actual claim experience, expenses and other factors for the policy year. For the present purpose, it will be assumed that billing premium reasonably approximates the cost of the plan.

The premium is typically expressed as a specified monthly premium for employee coverage regardless of age and sex. There are one or more additional premiums for dependent coverage, depending upon the number of separate dependent classifications used. These are essentially averages that through experience rating, incorporate the groups' actuarial characteristics of age, sex, dependent composition, geographical distribution of employees, type of industry, and claim experience. Such average premiums are changed annually to reflect recent claims experience, and the anticipated increases in health care costs for the coming year. This would include provision for inflated health care charges due to cut backs in Medicare and Medicaid payments, i.e. the "cost shift" to privately insured persons.

Since the per employee and per dependent unit premiums are adjusted each year on an overall basis, and remain broad averages, the actuarial value of the plan for each employee is not readily available. In this case, the Treasury method for allocating imputed income is still inequitable to employees. Young employees would be allocated imputed income in excess of the actuarial value of the plan to them. Older employees would be allocated less imputed income than their actuarial value, and would enjoy a subsidy. Under this system, employers might become reluctant to hire older workers. Likewise, a firm's employees living in low cost areas would subsidize their fellow employees living in high cost areas. In any given group of employees, there would be much cross-subsidy, or redistribution of imputed income for tax purposes.

Under the Treasury plan, with exemption amounts, an entire group might escape imputed income if the group's average age were low, or the bulk of the employees lived in low cost areas, or the group enjoyed better than average health. Conversely, a group with a high average age, or heavy concentration of employees in high cost areas, or worse than average health would be much more likely to be taxed. The impact on individual employees could vary sharply. For example, an employee living in Los Angeles might not have any imputed income if the rest of the firm's employees worked in Greenville, South Carolina. That would be very unfair to other Los Angeles workers employed in smaller local firms, and exposed to large taxes. Under this approach, an employee's imputed income would mainly depend upon the overall actuarial characteristics of his firm, and not at all on the actuarial value of the plan to him.

Another example of this unpredictability is when an employee changes employment from one group to another with a different age or sex distribution, different mix of employees by geographical area, or different type of industry. Under the Treasury method, his imputed income may change sharply in either direction. For example, a Washington, D.C. representative of a national bank could suddenly have substantially more imputed income if he or she changed employment to represent a large mining company, with no change in coverage. Similarly, if a representative of a Macon, Georgia firm changed to represent a Los Angeles firm, imputed income would also increase.

Overall, many inequities exist in allocating imputed income. They are such that inevitably many employees will be either lightly taxed or not at all, at the expense of others who will carry a disproportionate share of the burden. Employees will often be exposed to tax in a haphazard and unpredictable manner, especially upon changing employment, and will likely find explanations difficult to understand or accept.

Persons Without Employer Provided Health Benefits

The proponents of employee health benefit taxation claim that the present system is unfair to those without employer plan coverage. Such persons who desire health insurance normally purchase individual policies. The unfairness lies in the fact that premiums for individual policies are paid with after tax dollars, as contrasted to the non-taxable status of employer contributions to group health insurance.

In order to place this matter in perspective, we have estimated that as of the end of 1982, about 175 million Americans under age 65 were either covered under employee health plans or under individual health policies, or both. Of that number, we estimate that about 13 million had individual insurance only. Thus the advocates justify curtailing a tax preference that benefits 162 million persons, in deference to 13 million persons who have only individual insurance.

In our view, this "inequity" between those with and without employer coverage is greatly exaggerated, and cannot justify the imposition of a tax with so many negative effects on employees. In our mobile society, workers often change employment and over most of their working careers will be covered by employee health plans. If there are intervals between employer provided group insurance, individual policies are available, and that accounts for many of the 13 million with individual coverage. Such policies are usually lapsed when the insured goes to work for a firm with group coverage.

If there is an "injustice", it concerns those who never have access to employer provided group insurance. We believe that such persons represent a very small proportion of the workforce. To the extent that certain workers depend upon individual policies for long periods of time, the Administration and Congress should provide tax relief. That may be done directly by allowing such workers to deduct part or all of their individual health insurance premiums. Until recently, there was provision in the tax law to deduct part of such premiums, but that was repealed in 1982. It would seem wiser for Congress to reassess whether the individual premiums of a relatively few workers should be exempted, rather than to impose an inequitable tax on most employees.

III. The Impact of Health Benefit Taxation on Employers and Federal Revenue

A major argument for the taxation of employee health benefits rests upon the belief that the growth of such benefits has eroded the nation's tax base. As a result, marginal tax rates are said to be higher than necessary, and that health benefit taxation represents desirable tax reform. Other advocates are mainly concerned with the federal deficit, and simply see the taxation of employee benefits as a new source of federal revenue.

Tax Reform

There is general agreement that the current tax code is very complex. Tax reform has become a popular issue, and most proposals involve the elimination or curtailment of various deductions and exclusions from income. There are a number of choices that could be made, such as deductions for state and local taxes, interest paid, charitable contributions, IRA contributions, etc. If tax reform is to involve such a broadening of the tax base, a guiding principle should be that all taxpayers are treated fairly and generally in accordance with ability to pay.

In our view, employer contributions to health plans is one of the worst choices that could be made to expand the tax base. As noted in Section II, in connection with the Treasury plan, it would produce a host of inequities in the distribution of taxable income among taxpayers. Furthermore, it is a highly regressive tax since the allocated taxable income does not significantly vary by cash income level. Even if the tax reform were intended to be revenue neutral in the aggregate, through reduced tax rates, it is likely that the bulk of the tax burden would fall on those that can least afford it. This cure would be truly worse than the disease.

Deficit Reduction

With respect to those who anticipate a new source of revenue for deficit reduction, there may be considerable disappointment. The imposition of this kind of erratic and arbitrary taxation will create many problems for both employers and employees. The resulting changes in behavior are not very predictable, and the actual new revenue may fall short of that expected.

Let us first examine the practical problems that would be faced by employers. The imposition of a tax on employer contributions to a group health insurance plan, will increase the employer's administrative costs. That will reduce federal revenue from corporate income taxes to the extent that corporate profits are reduced, or increase the cost of goods and services to consumers. The following considerations illustrate the likely impact on employers.

(i) Large employers can have many health insurance plans in effect, but there is usually not more than one at a given location or for a specific bargaining unit. All such plans may not have been rated separately in the past, but now each would have to be separately treated for imputed income purposes. It is not uncommon for a large employer to have dozens, or a hundred or more plans in effect, reflecting collective bargaining activity with many unions. The need to treat a multitude of plans separately for imputed income purposes will increase administrative costs, for both large employers and insurance carriers.

(ii) The majority of workers have group health insurance, and although a tax cap may exempt many from paying tax, an employer must be prepared to establish appropriate records for all employees under the group plan. A key expense consideration will be the process by which the employer's cost is allocated to each employee. The more equitable the allocation of imputed income is to employees, the more expensive it is likely to be to administer.

(iii) Under the Treasury proposal, the cost of health coverage must be determined in advance of the payroll period. If the actual cost cannot be determined in advance, estimates are to be used. There are penalties on the employer if estimated costs are subsequently found to be not reasonable. Large fluctuations in group claim experience are not uncommon, and may frequently exceed what the Treasury regards as a reasonable prospective estimate. It is evident that employers are to be subjected to a new chapter in regulatory control and potential financial liability.

(iv) Special adjustments will be necessary for employees who add or drop dependent coverage during the year. Special calculations will be required for newly hired and terminating employees. Expensive changes to electronic data processing systems will likely be required.

(v) The new imputed income will increase all employers' social security taxes. This may be especially difficult for the small employer, who will also be pressed by higher bookkeeping costs.

(vi) Special accounting problems may arise in relating an employer's billing premium to true cost determined after the end of a policy year. To the extent that the employer's true cost is less than premiums, through dividends or other credits returned to him, the imputed income to employee should also be reduced, perhaps retroactively. That could entail considerably more complications in accounting and recordkeeping for the employer.

It is ironic that an Administration committed to less regulation and federal reporting requirements should be proposing a tax change that would add extensive new employer administrative duties. It is very likely that many employers will explore the opportunities for legitimate tax avoidance. The incentives are to minimize administrative problems and to spare employees from an inequitable and haphazard tax burden. In addition, union leaders will also be interested in tax avoidance on behalf of their membership.

The general thrust of the tax avoidance arrangements will be to reduce employer contributions to the group health insurance coverage, to eliminate tax liability, and to shift an equivalent amount into benefits which are either completely tax free or at most tax deferred for many years. An example of the former is increased vacation allowance, while examples of tax deferred benefits are pension plans and company contributions to savings programs. The particular approach would depend on the amount of contribution to be shifted and other factors such as the distribution among employees of tax liability. Although an employee's contribution to his or her health insurance plan would increase, the tax would have been avoided. The increased tax free or tax deferred benefits will leave the employee in about the same position as before the tax was imposed. Both large and small groups could implement tax avoidance arrangements, with the aid of in-house expertise or through consulting firms.

Although it is difficult to forecast the extent to which employers and unions will make tax avoidance changes, it is likely that many will. A tax that falls in an inequitable and often haphazard fashion will be difficult for employees to understand and accept. An employer who can offset an unpopular tax is likely to do so. The result will be that much less tax revenue will be realized by the treasury. To illustrate this point, the firm of Price Waterhouse analyzed the Treasury Health Cost Containment Tax Act of 1983. In that proposed legislation, taxes on employer contributions to health benefits were expected to generate $27 billion from 1984 through 1988. According to Price Waterhouse, an equally reasonable assumption was only $6.5 billion. The difference was due to different views of the extent to which taxable health benefits would be shifted to non-taxable benefits, and other factors.

IV. Cost Containment

The rapid acceleration of health care costs in recent years has focused attention on the need for improved cost containment. A current theory is that more effective cost containment would result if there were more competitive marketplace forces at work in the health care industry. Advocates of the theory wish to encourage insurance plans with reduced benefits and more employee cost sharing. For those covered under such plans, more cost sharing is expected to result in less demand for health services and thus lower prices through greater consumer cost sensitivity. This, in turn, is expected to stimulate competitive reactions from providers and ultimately result in cost containment for all patients.

The present lack of marketplace competition is attributed in large part to the tax free status of employer contributions to health insurance. That is said to have encouraged employees to seek "excessive" amounts of insurance, thus insulating them from significant out-of-pocket expense and making them insensitive to health care costs. The proposed taxation of health benefits is expected to motivate employees to change to lower premium plans with more cost sharing features, which is thought to be the route to cost containment for all.

The need for improved controls on health care costs is not in dispute. Many employers in recent years have increased deductibles and installed other cost containment provisions in an effort to reduce plan outlays, without the presence of a health benefits tax. The justification of the proposed tax as a cost containment measure, however, rests upon (1) a theory that the tax itself will result in significant numbers of employees voluntarily shifting to plans with more cost sharing, and (2) a theory that more cost sharing will actually result in more cost containment for all patients. It is important to consider the plausibility of these theories before complex tax legislation, with many adverse impacts, is enacted in the name of cost containment.

Let us first consider the likelihood that the tax will result in a significant number of employees voluntarily becoming covered under plans with more cost sharing. The actual number of employees affected by the tax will depend upon the methods of calculating imputed income, the level of the exemption amounts, and the prevalence of tax avoidance arrangements. It is clear, however, that for those employees who do become liable, the tax would represent an increase in the cost of their insurance. A decision to seek less insurance will vary greatly with the employee's circumstances. These would include the amount of tax involved, a family member's health status, the nature of the reduced benefits in the lower premium plan, and the employee's degree of aversion to the financial risk of medical expenses.

The relative ease with which the employee could change to a lower premium plan is also of importance. In this regard, there are two situations to consider. The first is where a single group health plan is to apply without any choice of insurance plans available. The second is where there would be a legal requirement for an employer to offer at least two conventional insurance plans with different benefit levels.

(A) Employer maintains a single conventional insurance plan.

Employers typically offer either a single company wide insurance plan, or a single plan for all employees at a given location or in a specific bargaining unit. If the tax motivates some employees to desire a lower premium plan, they must secure the employer's agreement to change the plan for all employees. If the plan is under collective bargaining, union agreement would be needed as well. Before agreeing to a plan change for all employees, the employer must be convinced that most employees would willingly accept a plan with a higher deductible or coinsurance or which covered fewer expenses, to satisfy a minority. For most groups, the likelihood of such a change is very low for the following reasons.

(i) Most people tend to be risk averse with regard to health care. The preference for high level health insurance protection reflects a desire to be relieved of financial risk and emotional pressure on the occurrence of accident or sickness. At the end of 1982, approximately 175 million Americans under 65 had one or more forms of coverage under group and individual policies. Over 90% of these persons had major medical protection, which is the broadest form of protection available. It is doubtful that any significant proportion of employees will voluntarily seek more out-of-pocket exposure to hospital and medical expense, or will wish to have fewer services covered.

(ii) The employer is not likely to change to a lower premium plan to satisfy a minority of employees, and risk resentment from the majority. If collective bargaining is involved, the union leadership would face the same dilemma. A plan with more cost sharing might well be resented by employees who either are not liable for tax or who are being subsidized by other employees by the way the rules are written.

It would be logical to expect that group insured persons would continue to be risk adverse, despite the presence of a new tax. There is little reason to believe, therefore, that any significant number of employees will voluntarily seek less insurance as a result of the tax on employer contributions. Those who do are likely to be attracted only to plans that preserve hospital and surgical coverage at the expense of vision, dental and other ambulatory care benefits. When the difficult employee relations problems of employers are also considered, we would conclude that few groups are likely to change to lower premium plans on account of health benefit taxation.

B. Employer offers a choice of two insurance plans.

Some proposals imposing the tax on employer contributions have also required employers to offer two insurance plans, one costing less than the other. The employer would probably be required to make the same contribution to each plan, and provide a rebate to an employee if the premium for his plan were less than the employer's contribution. Under this approach, any employee motivated by the tax to seek a lower premium plan could do so directly. This avoids the problems in changing a single plan that applies to all employees, and could result in more employees becoming covered under plans with more cost sharing features. The choice of plan process, itself, however, will produce severe distortions between the cost of the insurance plans, which will eventually make employee choice meaningless.

The risk averse nature of people described previously will initially limit the number of employees changing to lower premium plans, especially if significant cost sharing of hospital and surgical expense is involved. Those who do change, however, will be less likely as a class to need medical care in the near future than those who remain in the higher premium plan. That is because some of the employees who might be attracted to the lower premium plan will not change if future medical expenses are anticipated, which is known as adverse selection.

Adverse selection, when a choice of plans is available, is a natural consequence of the tendency of employees to act in their own best interests when making their decision. The degree to which it occurs depends upon the benefit differences of the two plans. Employees that anticipate large inpatient expenses for elective surgery in the near future will avoid a plan that requires more cost sharing of hospital and surgical expense. Employees with chronic illnesses, requiring frequent physician office visits and prescription drugs will avoid a plan with little or no out-of-hospital coverage. It is difficult to control adverse selection without severely limiting in various ways the employees freedom to choose.

The subsequent effect of adverse selection will be a major distortion in the premiums required for the two insurance plans. At each annual opportunity to change plans, the rearrangement of employees by their medical needs will become more pronounced. The cost of the higher premium plan will increase much more rapidly than will the cost of the lower premium plan, which will force a revision in the way the employer's contribution is computed. If the contribution were linked to the high premium plan, the employer would soon be faced with much higher total contributions. This would be due to the rapidly increasing high premium plan costs, and the requirement to provide rebates to those in the lower premium plan. In order to control his cost, the employer would most likely set his contribution each year in a manner unrelated to the specific premium for any plan. This would force larger and larger employee contributions under the high benefit plan, as the premium rose faster than the employer contribution.

As a result, even employees who would naturally desire the higher premium plan may feel compelled by high employee contributions to change to the lower premium plan. This could be disastrous for financially pressed lower paid employees who select the low premium plan, and then suffer the expenses of a major illness or accident. It is also a disaster for less healthy employees in the high premium plan, who pay ever increasing contributions for their coverage. The distortions produced in premium and employee contributions are such that employees will be less and less able to make rational choices with respect to price. The financial problems and employee discontent engendered would eventually either force a return to a single plan, or a narrowing of the difference in benefits between the two plans, or a cross-subsidization of the two plans' premiums. The smaller the group involved, the faster the breakdown is likely to come.

The requirement to offer two insurance plans would also mean much additional administrative expense for employers. The complications of permitting annual changes and providing rebates will drive up record keeping and electronic data processing expense. Many employers are likely to attempt to minimize this situation through tax avoidance arrangements.

Overall, the tax together with a choice of plan requirement might temporarily result in more employees changing to low cost plans. Through the effects of adverse selection, however, the choice of plan structure will eventually break down. The two plan approach would either be abandoned or the plan differences would be narrowed. Another solution might be to cross-subsidize the two plans, but all of these outcomes are contrary to the original purpose of the two plans. The end result will be few employees covered under low premium plans. The added burdens on employers will make tax avoidance arrangements more attractive.

It was noted earlier that the link between the tax and better cost containment rests upon two theories. The first is that the tax will lead to a significant number of employees becoming insured under lower premium plans with more cost sharing. We have seen that that is not likely to result whether employers have a single plan or provide for employee choice. The second theory is that greater cost sharing will actually result in more cost containment for all patients. Let us consider the likelihood that that will occur.

Persons covered under plans with more cost sharing are expected, through their heightened cost sensitivity, to become more astute buyers of health care services. The average consumer, however, is not equipped to judge whether prescribed medical services are needed, or to shop hospitals and physicians for price value. Furthermore, most often the consumer would lack the emotional composure required to reach an informed decision. These are some of the reasons for the widespread consumer acceptance of comprehensive health insurance. When persons subject to more cost sharing avoid medical care, there may be longer range impacts on health status that are not presently well understood. More evidence needs to be accumulated to support the view that cost aware consumers can fulfill a marketplace role, without impairing their health in the process.

Under the theory, cost containment will be improved for all patients when hospitals and physicians respond to marketplace pressures and become more efficient and competitive. The marketplace pressures are to be produced by the persons covered under plans with greater cost sharing, who will utilize fewer services. Since, however, these persons are expected to be few in number, providers can simply increase fees. Most patients will remain covered by comprehensive insurance, and it will not be difficult to compensate for any income losses from patients with greater cost sharing plans. In addition, persons with more cost sharing on out-of-hospital benefits may seek hospital admission in order to have diagnostic tests covered. This could drive inpatient costs even higher. As long as these reactions are possible, the objective of cost containment for all patients through more cost sharing plans is not likely to be achieved. A minority of persons with less insurance coverage, is not likely to induce much provider competition or cost containment.

In summary, the two theories underpinning the justification of the tax as a cost containment measure are not very plausible. Significant numbers of employees will probably not change to plans with more cost sharing. Those who do are not likely to produce the marketplace reactions from providers that will lead to cost containment for all patients. The impact of the tax on cost containment, therefore, is expected to be negligible.

V. The Need For An Employee Health Benefit Tax Preference

In the preceding sections, we have seen that the major arguments supporting health benefits taxation are fatally flawed. The prospects of rampant inequity, regressive taxation, doubtful revenue, administrative expense and a failure to improve cost containment do not permit serious support for the proposal. Thus far, we have dealt only with the reasons why such taxation would not achieve its purposes. It is appropriate now to discuss the reasons why the tax preference has been historically good public policy and should be maintained.

In our view, tax incentives can be justified if desirable public objectives are achieved through the appropriate response of private enterprise. For many years there have been tax incentives to encourage employers to provide health benefits to employees. We believe that a major public objective has been achieved in that 162 million persons -- workers and their families -- have one or more forms of group health insurance protection. Secondly, that achievement has been accomplished by private enterprise, which, through competition in a free economy, has delivered its product to the best advantage of the consumer.

We believe the wisdom of the tax incentives has been well proven for the following reasons.

Most Americans today recognize that medical expense insurance is a basic necessity. They realize how reckless it is to risk financial devastation on account of accident or sickness. Adequate health coverage eliminates a major source of fear and uncertainty in people's lives, and provides access to health care services that might otherwise be unaffordable. The existence of Medicare and Medicaid demonstrates government's commitment to the need for coverage among those for whom public programs are necessary. It is the private sector that has met that same need for the bulk of the population through employee health benefit plans.

The ability of private companies to offer group insurance goes hand in hand with the tax incentives for employers and employees. The relationship can be explained by a brief description of how group insurance is underwritten.

Under current industry practice, medical expense benefits can be made effective for an employee group without individual medical evidence of insurability, if at least ten employees are involved. The usual rules only require that the employees enroll when first eligible, and that they be actively at work when coverage is to become effective. Dependants are also covered on a non-medical basis under similar rules. This liberal approach to offering coverage is of enormous importance to the public, since many persons become group insured who would have difficulty obtaining medically underwritten individual insurance.

Insurance companies can appropriately price group health insurance and maintain acceptable financial experience, despite the absence of evidence of individual insurability. The reason is that a high degree of employee participation in the plan is required. If the plan is contributory, at least 75% of employees must enroll, and all employees must be covered under non-contributory plans. With these participation requirements, a reasonable cross section of risks is obtained which provides stability to the financial experience. These rules ensure that both young and old employees enroll, and also the healthy as well as those who have medical problems.

There is usually no difficulty in getting employees to enroll, since the value of health coverage is appreciated and the employer pays all or nearly all of the cost of the plan. Furthermore, the employer contribution is not taxable income to the employee. There is a supportive relationship between tax incentives which encourage employers and employees to participate in group health benefit plans, and the ability of insurers to successfully underwrite such coverage without medical evidence of insurability. This has worked so well that the protection of 162 million Americans under 65 has been accomplished by the private sector without any need for federal intervention.

If employer contributions to health insurance were to be taxed, participation in the employer's plan would become less attractive to various employees because of the additional cost. As an example, young employees would begin to realize that they are paying more income tax than they should, as they are subsiding older workers. With the advantage of young age and good health, such employees could find more competitive health coverage outside the employer's group plan. As they withdraw and participation falls, the cost of the group plan will rise reflecting the changed spread of risk. Such changes produce sharp premium increases, which in turn encourage more employees to seek more competitive coverage outside the group plan. That further increases the instability, and the cycle continues.

Another category of employee that could be forced out of the group plan by the proposed taxation is the low income worker who simply can no longer afford health coverage. That would be especially true of low income workers in the large cities with high medical costs. In that case, the levels of uncompensated hospital and medical care will rise. When that occurs, providers raise prices to those who pay, which means increased insurance premiums. That, in turn, would mean higher taxes for those who remain under the group plan, and even more incentive for the young and healthy to seek more competitive coverage elsewhere.

The negative effects of health benefit taxation on group plan participation will increase over time. Under the Treasury plan, the exemption amounts of $70 per month and $175 per month for 1987 would be indexed to the Consumer Price Index in subsequent years. Premium rates, however, normally increase faster than the CPI. That is because they account for changes in both medical prices (which usually increase faster than the overall CPI), and the utilization of medical services. Over time, therefore, taxable income will increase as a percentage of the employer contribution, despite the indexing of the exemption amounts. There is also a possibility of future reductions in the exemption amounts. As evidence of that, it might be noted that the $50,000 group life insurance exemption has never been increased, and it is now proposed under the Treasury plan to remove the exemption completely.

Overall, the tax will create ever increasing incentives for employees to withdraw from the group plan. The eventual outcome will be a severely restricted ability of insurers to underwrite group health insurance on a non-medical basis, especially for small and mid-size groups.

As a result of weakening the private group insurance mechanism, more and more employees and dependents will encounter difficulty securing adequate coverage at a reasonable price. As the proportion of the population without coverage grows, the incidence of financial ruin on account of accident and sickness will increase, along with levels of uncompensated care in hospitals. These conditions will bring forth pressures to expand public insurance programs, not withstanding the fact that Medicare and Medicaid now consume a very large share of the federal budget.

The encouragement of health insurance coverage through tax incentives has been enormously successful in terms of social and economic accomplishments. The present system of employment related health benefits was built up over several decades, and works very well. Americans have come to regard employer sponsored health protection almost as an automatic feature of employment, providing benefits of great value. In our view, no change should be made in tax incentives which might impair the ability of the private sector to provide essential insurance protection to the public. Over the long term, it is our private system of health care delivery that is at stake.

REVENUE ESTIMATES FOR S.640
THE HEALTH COST CONTAINMENT
TAX ACT OF 1983

September 1983

A Study Prepared For

The Health Insurance Association of America
The American Dental Association
The American Optometric Association
The Blue Cross and Blue Shield Association
The National Association of Private Psychiatric Hospitals
The Society of Professional Benefit Administrators
The American Dental Hygienists' Association

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September 22, 1983

Mr. James A. Dorsch
Health Insurance Association
  of America
1750 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Dorsch:

We enclose our report entitled "Revenue Estimates for S.640: The Health Cost Containment Tax Act of 1983." The purpose of this study was to review the existing revenue estimates for this proposed tax and to offer our estimate of the amount of revenue that it might yield.

The report reviews the estimates prepared by the Department of the Treasury and by the staff of the Joint Committee on Taxation. It also draws on other research in the field of taxation of employment-related health insurance.

In preparing our estimate of the tax revenue of S.640 we have considered alternate assumptions for the growth in employer contributions to health plans and the degree of shifting to non-taxable benefits. In contrast to government revenue estimates, we also consider the feedback effects of the legislation on other tax revenues. We conclude that S.640 would most likely yield 5 year revenue of $14.2 billion, as compared to $26.5 billion for the Joint Committee on Taxation and $27.4 billion for the Department of the Treasury.

We appreciated the cooperation and assistance we received from you and the members of your association in the preparation of the study.

Yours very truly,

Price Waterhouse

SUMMARY

The Health Cost Containment Tax Act of 1983 (S.640) should yield less tax revenue than the Treasury Department and the staff of the Joint Committee on Taxation have estimated for the following reasons:

- Shifting of taxable health benefits to non-taxable benefits
- Slower growth in employer contributions to health plans
- Feedback effects of the legislation on other tax revenues

The following table compares revenue estimates prepared by the Treasury Department, the staff of the Joint Committee on Taxation, and Price Waterhouse. All estimates are in billions of dollars.

Revenue Estimates--S.640 ($ in billions)

	Fiscal Year					
Source	1984	1985	1986	1987	1988	Total
Price Waterhouse	$1.746	$2.765	$3.094	$3.097	$3.487	$14.189
Department of the Treasury	$2.108	$4.190	$5.617	$6.868	$8.629	$27.412
Joint Committee on Taxation	$2.120	$4.077	$5.433	$6.638	$8.273	$26.541

The revenue estimates prepared by Price Waterhouse are lower than the other two sets of estimates due to differences in assumptions about: 1) the rate of growth in employer contributions to health plans and 2) the extent to which non-taxable benefits replace benefits that become taxable to employees. The Treasury Department and the staff of the Joint Committee on Taxation assumed higher rates of growth in health plan contributions than did Price Waterhouse, along with a smaller shift to non-taxable benefits. In addition, tax revenue estimates prepared by the Treasury Department and the staff of the Joint Committee on Taxation traditionally do not include feedback effects of the proposal on other tax revenues.

Based on our analysis of the proposed tax, we find that:

- The projections of taxable income used by the Joint Committee and Treasury staffs to generate revenue estimates are based on the assumption that employer contributions to health plans grow at a rate of a 12.6 percent per year. An 8.75 percent growth rate in premium contributions would lower the amount of "excess" contributions subject to the tax from $103 billion to $75 billion over 5 years. This would lower the tax revenue produced by the bill by $7 billion over the 5-year period.
- Treasury and Joint Committee staff estimates are based on the assumption that only 15 percent of the newly taxable health care benefits will be replaced by non-taxable benefits (reducing the tax base from $75 billion to $66 billion over 5 years using our premium growth assumption). A 25 percent rate of shifting, would lower the base of the tax from $66 billion to $60 billion for the 5-year period. The tax revenue would decline by $2 billion over 5 years.
- S.640 would reduce the incomes, and thus, the tax payments of health insurers and health service providers. These feedback effects or tax revenue offsets would total $3 billion over the 5 years.

> Certain other effects of the bill, such as the administrative burden placed on employers, have not been considered in any revenue estimate to date. While these effects are difficult to quantify, they would reduce the bill's revenue effect even further.

Under a reasonable set of assumptions, the revenue generated by S.640 could range from approximately $7 billion to approximately $26 billion over a 5-year period. Although there is considerable uncertainty about the revenue impact of the bill, we believe that under the most probable set of assumptions it would generate approximately $14 billion over a 5-year period.

I. INTRODUCTION AND SUMMARY

Revenue estimates for The Health Cost Containment Tax Act of 1983 (S.640) were prepared by the staff of the Joint Committee on Taxation (JCT) and the U.S. Treasury Department Office of Tax Analysis (OTA). This report presents our range of estimates of tax revenue from S.640. Our analysis focuses on the Treasury and JCT staff estimates and adjusts them for a lower assumed growth rate of health care benefits due to moderation of the general inflation rate, for a higher assumed rate of shifting to non-taxable benefits, and for other quantifiable revenue effects. We conclude that if the reactions of affected taxpayers are considered and if a more moderate assumption about rates of growth of employer health plan contributions is used, S.640 should yield less revenue than the earlier estimates suggested.

A. Background of this Report

This report was prepared at the request of the Health Insurance Association of America (HIAA), The American Dental Association, The American Optometric Association, The Blue Cross and Blue Shield Association, The National Association of Private Psychiatric Hospitals, The Society of Professional Benefit Administrators, and The American Dental Hygienists' Association.

The HIAA has voiced its opposition to S.640. It has questioned the proposal's effectiveness in achieving its two goals--to control health care costs and to raise tax revenues.

During the course of preparing this report, Price Waterhouse staff met with staff of the Joint Committee on Taxation. JCT staff explained their assumptions and provided some of the data used in their analysis. The Treasury Department indicated that their analysis differed only slightly from that of the staff of the Joint Committee on Taxation. The analysis in this report is not based on complete data from either JCT staff or Treasury. Instead, it relies on their representation of their methodology and incorporates the data they provided.

B. Summary of Findings

1. Reasonableness of Assumptions

The JCT staff and Treasury revenue estimates are derived in part from 1977 data, which was adjusted to produce estimates of health plan contributions through 1989. A more current source would be preferable, albeit expensive to produce. According to Treasury, JCT staff, and the Department of Health and Human Services, a revision of the 1977 data is in progress. When this information is available, it will allow Treasury and JCT to revise their revenue estimates.

Both Treasury and JCT staff project that employer health care contributions will grow at a rate of 12.6 percent per year. Given current levels of inflation, these projections appear too high. Our calculations assume an 8.75 percent annual growth rate in employer contributions to health plans. Historically, changes in health insurance premiums have been related to changes in the Consumer Price Index. From 1970 through 1981, the ratio of annual percentage increases in private health insurance premiums to annual percent increases in the Consumer Price Index was 1.75 (Appendix A). Both the Treasury and the staff of the Joint

Committee on Taxation assume annual inflation rates of five percent per year or less. With inflation at five percent and with premiums growing at 1.75 times the rate of change in the Consumer Price Index, the annual growth in premiums would be 8.75 percent. Accordingly, we have used this rate to derive our estimate of "excess contributions". In contrast, Treasury and JCT staff assume that premiums will increase at an annual rate of 12.6 percent if employer contributions remain untaxed. This figure is based on their projections of medical cost inflation and their assumptions about labor force participation and the level of coverage per employee.

In addition, both Treasury and JCT staff assume that 15 percent of the newly taxable benefits will be shifted to non-taxable benefits after five years. We consider shifts of between 10 and 50 percent of the taxable portion of health benefits to be reasonable and use a 25 percent shift in our analysis. This shift results in total employer health care contributions being lower than they would have been had health benefits remained untaxed.

2. Additional Quantifiable Effects

Government revenue estimates traditionally do not include "feedback" or "second order" effects of the tax legislation under consideration. As a result, the prior estimates do not include at least two quantifiable effects of the reduction in health care insurance caused by S.640:

- Health insurers and their employees will make less money and thus, will pay less in taxes.
- Health service providers will make less money and thus, will pay less in taxes.

We choose to include these revenue "offsets" in our analysis.

The Price Waterhouse calculation of the revenue offsets due to S.640 is based on a partial feedback analysis of the proposed tax, rather than a general equilibrium model of the effects of the tax. A general equilibrium approach would consider the income and tax effects of all alternative uses of the tax revenues. However, since total tax payments by other affected sectors of the economy are not predictable we feel that a general equilibrium approach is not appropriate. The partial feedback approach that we have employed incorporates those changes which are subject to reasonable approximation, i.e., tax payments by health insurers, health service providers, and their employees.

C. Outline of the Report

The remainder of this report is organized as follows:

- Section II--Background on The Health Cost Containment Tax Act of 1983 (S.640). This section describes some of the major provisions of the bill.
- Section III--Summary of Other Estimates. This section reviews the revenue estimates produced by the Treasury and the staff of the Joint Committee on Taxation. It also discusses the work of other researchers which is relevant to taxation of health benefits.
- Section IV--Additional Effects. An analysis of S.640's effects should include its tax impact beyond the tax on employees. This section lists these effects and describes how they should be quantified.
- Section V--Revised Revenue Estimates. This section applies the results of Section IV to the estimates of Section III to produce a new range of revenue estimates for S.640.
- Section VI--Conclusion

II. BACKGROUND ON THE HEALTH COST CONTAINMENT TAX ACT OF 1983 (S.640)

The Health Cost Containment Tax Act of 1983 has two objectives: to raise revenue and to control medical cost inflation.

A. Goal 1: Raise Revenue

The bill would include in an employee's gross income a portion of the employer contributions for medical insurance and other health benefits. Under current law, these contributions are excluded from employees' income.

S.640 would limit this exclusion. In 1984, contributions in excess of $70 per month per single employee and $175 per month for employees with families would be taxable to employees. Thereafter, the "cap" would be indexed to the Consumer Price Index and rounded off to the nearest whole dollar. "Excess contributions" would also be subject to payroll taxes (FICA) and unemployment taxes (FUTA).

B. Goal 2 Control Medical Cost Inflation

S.640 would increase the cost of health insurance to the consumer. The bill's proponents contend that consumers will therefore reduce their expenditures on health insurance. They argue that this reduction in expenditures will cause insurers to lower their rates and providers to lower their prices. Although no analysis of these contentions is offered here, we note that to the extent that medical costs are contained, the amount of "excess contributions" will be reduced. This will lower the tax revenue of the bill.

III. SUMMARY OF OTHER ESTIMATES

A. Office of Tax Analysis, Department of the Treasury

The Treasury Department has estimated that S.640 will yield the following sums over the next 5 Fiscal Years. Amounts listed are in billions of dollars.

Table 1

S.640--Treasury Department Revenue Projections

	FY84	FY85	FY86	FY87	FY88
General Revenue	$1.546	$3.092	$4.141	$5.064	$6.306
FICA	.562	1.098	1.476	1.804	2.323
Total	$2.108	$4.190	$5.617	$6.868	$8.629

Thus, the Treasury Department projects that S.640 will yield $27.4 billion in tax revenues over the next 5 Fiscal Years.

These revenue estimates are based on the 1977 National Medical Care Expenditure Survey (NMCES) commissioned by the Department of Health and Human Services to estimate expenditures on health care. These 1977 data were used by the Treasury to project health care expenditures through 1989. "Excess contributions" and hence tax revenue estimates were derived from these projections. As shown in Appendix B, "excess contributions" are extremely sensitive to projections of the growth rate in health benefit contributions.

In addition to the projection of total "excess contributions," the Treasury made the following additional assumptions about and adjustments to their model:

1. Substitution of other Fringe Benefits

Employees who participate in "cafeteria" plans or who can negotiate their package of compensation and benefits have some ability to select non-taxable benefits in lieu of taxable benefits. Employees who take wages in lieu of health benefits do not change the tax yield. However, employees who negotiate a shift from taxable health benefits to tax-deferred or tax-free forms of compensation do reduce the tax yield. Employers also have an incentive to shift health benefit costs to non-taxable benefits to reduce total wage bills. The Treasury assumes that non-taxable benefits will be substituted for taxable excess contributions at the following rates:

Table 2

Treasury Department Assumption: Shift to Non-taxable Benefits

	1984	1985	1986	1987	1988
Percent of newly taxable income shifted into non-taxable or tax deferred benefits	3	9	12	15	15

We consider total 5-year shifts of between 10 and 50 percent of the newly taxable health benefits to non-taxable benefits to be plausible. Our analysis assumes a 5-year shift of 25 percent.[1]

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[1] The assumption of a maximum 15 percent shift to non-taxable benefits after five years is a major untested assumption of the OTA and JCT analyses. For example, if the rate of shifting in each year is double the rate shown in Table 2, government estimates of the five-year tax revenue (unadjusted for revenue offsets) would fall by approximately $3.6 billion.

2. Income Tax Rates

The Treasury assumed that the average marginal tax rate (26 percent) would approximate the tax rates applicable to the newly taxable income. We have assumed the same average marginal tax rate.

3. Labor Contract Grandfathering

S.640 provides for an exemption from the tax for labor contracts executed before the legislation would take effect. The magnitude of the cost of this exemption was estimated by contacting various major unions to obtain data on health plan contributions. For the $70 single and $175 family monthly caps, Treasury estimates the grandfathering provision will reduce tax revenues by $845 million in 1984 and $204 million in 1985. Thereafter, these contracts will expire and excess contributions under future labor contracts will be subject to the tax. Our analysis makes the same assumption.

4. Incidence of Payroll Tax

Based on the empirical work on the subject, the Treasury assumed that employees are made to bear the full burden of the employer's portion of the payroll tax through a reduction in their wages. The reduction in employee wages reduces the income and payroll tax revenue yields of S.640. The Treasury assumed that employees bear this full burden in the short run as well. The Price Waterhouse analysis also assumes that employees bear the full burden of the payroll tax.

5. Inflation Assumptions

The March 1983 projections for the Consumer Price Index for urban wage earners (CPI-U) were used by the Treasury to project increases in the size of the tax cap. These projections are:

Table 3

Treasury Department: Inflation Assumptions

	1985	1986	1987	1988
Projected percent growth in CPI-U over prior year	3.61	4.88	4.72	4.57

We assumed that inflation would be 5 percent per year in the 1985 to 1988 period (as did JCT).

6. Insignificance of FUTA

"Excess contributions" are subject to federal unemployment taxes. However, after testing the effect of this tax, Treasury concluded that the yield from this tax was insignificant. Accordingly, we did not consider the tax yield from federal unemployment taxes in our analysis.

B. Joint Committee on Taxation, U.S. Congress

The Joint Committee on Taxation has estimated that S.640 will yield the following sums over the next 5 Fiscal Years. Amounts listed are in billions of dollars.

Table 4

S.640--Joint Committee Revenue Projections

	FY84	FY85	FY86	FY87	FY88
General Revenue	$1.546	$3.007	$4.005	$4.894	$6.047
FICA	.574	1.070	1.428	1.744	2.227
TOTAL	$2.120	$4.077	$5.433	$6.638	$8.273

The JCT staff projects that S.640 will yield $26.5 billion in tax revenues over the next 5 Fiscal Years.

With limited exceptions, JCT's estimates were derived from the same data sources and assumptions which the Treasury used. The exceptions are as follows:

1. Payroll Tax Rate

We have employed the JCT assumptions of payroll tax rate and the percentage of wages subject to the tax. These assumptions, which are identical to the Treasury estimates for 1985 through 1988 are shown below:

Table 5

Payroll Taxes--JCT Assumptions

	1984	1985	1986	1987	1988
Combined Payroll (FICA) Tax Rate	.1400	.1410	.1430	.1430	.1502
Percent of Total Wages subject to FICA	64.7%	64.1%	63.6%	6.30%	62.5%

Note that JCT staff made the simplifying assumption that the combined employer and employee payroll (FICA) tax rate was 14 percent in 1984. In fact, for this one year, the rate will be 13.7 percent--7 percent on the employer and 6.7 percent on the employee. This slightly higher rate caused JCT's estimate for fiscal year 1984 to be slightly higher than the Treasury estimate.

2. Inflation Assumptions

JCT staff assumed an inflation rate of 5 percent per year. The choice of an inflation assumption is important because the exclusion cap is indexed to the Consumer Price Index. Since the JCT staff assumed a slightly higher rate of inflation than did Treasury, it assumed that the cap would be slightly higher each year. With a higher cap, the amount of income subject to the tax is lower and thus, the revenue generated by the tax is lower as well. The Price Waterhouse analysis also assumes an inflation rate of 5 percent.

C. Other Research Relevant to Taxation of Health Benefits

1. The Rand Corporation

A recent Rand Corporation study provides insight into taxpayer reactions to a health care tax cap. Rand designed an experiment to determine how varying the cost of health care to consumers would affect their demand for health services. Rand selected participants randomly, assigned them randomly to a variety of low and high option plans, insured all participants itself and guaranteed those selecting low option plans that they would receive the difference between their plan's value and the high option plan in cash. The complete results of the survey are not yet available. However, based on evidence from 40 percent of the sample, Rand concluded that people whose copayments increase from zero to 25 percent will reduce their total health expenditures by 19 percent.[2]

This result indicates that if the cost of a given level of health insurance increases, consumers will purchase less health insurance and fewer health care services.

2. Taylor and Wilensky

Amy Taylor and Gail Wilensky of the National Center for Health Services Research of the Public Health Service have also estimated how an increase in the cost of health care to the consumer would affect demand for health care. Based on results of a model designed to identify factors which cause changes in health insurance premiums, they found that a 1 percent increase in cost to the consumer would reduce health care demand by 0.21 percent in the short run.[3] It is interesting to note that though their research method differed from Rand's, their result seems to corroborate that of the Rand study.

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[2] Phelps, Charles E., Health Care Costs: The Consequences of Increased Cost Sharing, November 1982.

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[3] Taylor, Amy & Wilensky, Gail, Tax Expenditures and the Demand for Private Health Insurance, in Market Oriented Reforms in Federal Health Policy, American Enterprise Institute, Washington, D.C., 1982.

IV. ADDITIONAL EFFECTS

The revenue generated by S.640 is not determined solely by the tax on "excess contributions." Additional major effects include reduced corporate income tax payments by insurers, reduced income and payroll tax payments by their employees and similar effects on health care providers.

A. Reduced Yield from Health Insurers

Based on the studies by the Rand Corporation and by Taylor and Wilensky, we anticipate that consumers would purchase less health insurance if S.640 were enacted. Thus, health insurers would have lower revenues if the bill becomes law. If their revenues fall, so will their profits and thus, their tax payments will be lower.

The Treasury and the staff of the Joint Committee on Taxation are aware that insurers' revenues will fall if the bill becomes law, but as a matter of policy, they ignore the impact of such "feedback" or "second order" effects on tax revenue estimates. We agree that the change in tax payments by insurers is a "feedback effect," but believe it to be subject to reasonable approximation and thus, appropriate for inclusion in the revenue estimate. Since this is not a general equilibrium analysis,[4] it is impossible to predict how the tax payments by other sectors of the economy would change.

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[4] A general equilibrium analysis would show who would receive money formerly spent on health insurance (e.g., providers of day care services) and would explain how this redistribution of income would affect tax revenues.

B. Reduced Yield from Health Care Service Providers

The tax would reduce the use of hospital and physician services. If their incomes fall, we would expect their tax payments to fall as well. Although this is also a "feedback effect," it too is subject to approximation.

Our estimate of the magnitude of these two effects is presented in Section V.

V. REVISED REVENUE ESTIMATES

This section presents our estimate of the tax revenue of S.640 based on a revision of the analysis performed by the staff of the Joint Committee on Taxation. The JCT analysis is used as a starting point for our analysis and differing assumptions are noted. As discussed previously, JCT and Treasury estimates are nearly identical, differing only in two minor assumptions. Our use of the JCT estimate as the basis of our revisions is based solely on the greater detail provided to us by JCT.

A. Premium Growth Rate

The starting point in our analysis is a revised estimate of excess contributions based on an annual premium growth rate of 8.75 percent versus the 12.6 percent rate used by JCT. We believe that this lower rate is appropriate due to current decreases in the rate of inflation and due to the historical relationship between inflation and the cost of health insurance premiums.

Total health insurance premiums rise for three major reasons: (1) health care inflation, (2) increases in the number of covered employees and (3) higher levels of coverage demanded by individuals. While health care inflation has exceeded the overall inflation rate, the recent moderation of the overall inflation rate should serve to moderate health care inflation as well. In addition, S.640 contains provisions which its proponents claim will moderate health care inflation.

Although the second and third factors cited above would tend to increase the growth rate of health insurance premiums above the rate of health care inflation, we find little support for the

Joint Committee staff's assumption that the growth rate of premiums will be more than twice the general inflation rate. (See Appendix A for historical data on health insurance premiums and inflation.) Thus we consider the plausible range of growth in health care premiums to be 8.75 percent to 12.6 percent (the Treasury and JCT assumption). Our preferred estimate of 8.75 percent is based on a multiplier of 1.75 times the inflation rate of 5 percent assumed by JCT.

The following table shows a comparison of excess contributions for premium growth rates of 8.75 and 12.6 percent.

Table 6

Excess Contributions ($ in billions)

	1984	1985	1986	1987	1988
Price Waterhouse Assumption (8.75%)	$11.380	$12.947	$14.724	$16.632	$19.183
Treasury/JCT Assumption (12.6%)	$12.505	$15.660	$19.591	$24.396	$30.480

Table 7 shows the tax revenues at premium growth rates of 8.75 and 12.6 percent, assuming that no shift from taxable to non-taxable benefits occurs.

Table 7

Preliminary Tax Revenues-- Before Shift to Non-Taxable Benefits ($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
Price Waterhouse Assumption (8.75%)	$1.980	$3.706	$4.675	$5.360	$6.187	$21.910
Treasury/JCT Assumption (12.6%)	$2.176	$4.394	$6.079	$7.670	$9.636	$29.957

The remainder of this chapter discusses our estimates of the revenue effects of S.640 on insurers and health care providers due to 1) the shift from health benefits to non-taxable benefits (thus lowering excess contributions subject to the tax) and 2) reduced tax revenues from insurers and providers.

B. Shift to Non-Taxable Benefits

The imposition of a tax on employer provided health benefits is likely to cause a portion of employee compensation to be shifted from newly taxed health benefits to untaxed benefits (such as dependent care or group term life insurance) or tax-deferred benefits (such as pensions). In this section we hypothesize the degree of this shifting. In the section that follows we trace its impact on the tax receipts from two groups: 1) health insurers and 2) health care providers.

In deriving their estimates, the Treasury Department and JCT staff assumed that 15 percent of the taxable portion of health benefits is shifted to non-taxable benefits after 5 years. As noted earlier, this assumption which is based on the fact that 15 percent of total compensation is currently received in the form of non-taxable benefits is the major untested assumption in their analysis. It relies on employees and employers treating taxable benefits at the margin in the same manner as compensation is treated on average. A strong case can be made for a greater degree of shifting at the margin, or for applying any shift to total health benfits rather than only those benefits deemed to be "excess". If the latter approach was taken, a modest percentage shift would reduce revenue estimates significantly.

Our analysis therefore assumes a 25 percent shift of excess contributions as compared to the 15 percent shift assumed by Treasury and JCT. Given that the "shift" applies only to the taxable portion of health benefits (12 percent of total health benefits) we feel that a 50 percent shift would be reasonable.[5]

The year-by-year shifts to non-taxable benefits that we have assumed are shown in Table 8 below:

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[5] The shift away from newly taxable health benefits is equivalent to an "elasticity adjustment" in reaction to the implicit increase in the the price to the employee of health coverage. There have been at least two efforts to measure this elasticity. Amy Taylor and Gail Wilensky estimated the price elasticity of demand for private health insurance to be -0.21. In other words, a one percent increase in price reduces sales by 0.21 percent. They hypothesized that the long run elasticity figure would be roughly -0.5, or a one-half of one percent decrease in insurance for each percent increase in price. In the Rand study cited earlier, the researchers found that for individuals going from a zero to a twenty-five percent copayment, demand for total health care falls by nineteen percent.

Table 8

Shift to Non-Taxable Benefits (Percentages)

	FY84	FY85	FY86	FY87	FY88
Price Waterhouse Assumption	5	15	20	25	25

The decrease in insurer revenues that results from the shift to non-taxable benefits is equal to the excess contributions (Table 6) multiplied by the assumed shift percentage (Table 2 and Table 8). The 5-year totals are as follows:

Table 9

Reduction in Excess Contributions Due to Shift to Non-Taxable Benefits -- FY84-FY88
($ in billions)

	Premium Growth Rates	
Shift to Non-Taxable Benefits	8.75%	12.6%
Treasury/JCT (15%)	$8.646	$12.367
Price Waterhouse (25%)	$14.409	$20.611

As a result of the above reduction in excess contributions, proportional changes occur in the estimated 5-year revenue of S.640 (unadjusted for insurer and provider offsets). Table 10 below presents the preliminary revenue estimate after these changes.

Table 10

Preliminary Tax Revenues after Shift to Non-Taxable Benefits
FY84-FY88 ($ in billions)

	Premium Growth Rates	
Shift to Non-Taxable Benefits	8.75%	12.6%
Treasury/JCT (15%)	$19.350	$26.323
Price Waterhouse (25%)	$17.642	$23.898

C. Revenue Offsets--Insurers

1. Allocation of Premiums to Benefits, Profits and Administrative Costs

The first step in deriving revenue offsets due to the shift to non-taxable benefits is to allocate the reduction in insurance premiums to benefits, administrative costs and profit. We assume that health insurance premiums are allocated as follows:

Table 11

Distribution of Health Insurance Premiums

80.0% -- paid to health service providers
5.5% -- gross margin
14.5% -- administrative costs
100.0%

This allocation is based on conversations with health insurers and on public statements by industry sources. Loss ratios (incurred claims divided by earned premiums) for group insurance vary from 65 percent for small groups to over 90 percent for large groups. The Blue Cross/Blue Shield Association states that roughly 90 percent of their premiums received are paid out for benefits. With loss ratios varying from 65 percent to over 90 percent depending on group size, we assume that 80 percent is a reasonable approximation of the industry-wide aggregate figure.

Net income divided by business receipts was 5.5 percent for all active corporations in 1979.[6] This figure represents the profit margin for all U.S. corporations and serves as a proxy for the profit margin of health insurers. Personal communications with Blue Cross/Blue Shield confirmed that this number is reasonable.[7]

With 80 percent allocated to benefits and 5.5 percent allocated to profit, the remaining 14.5 percent covers administrative costs.

Reductions in amounts paid to each category (benefits, profits and administrative costs) were obtained by multiplying the reduction in insurer revenues (Table 9) by the percent of revenues allocated to a category (Table 11). Assuming a shift of 25 percent and premium growth of 8.75 percent the shift to non-taxable benefits would cause the following reductions:

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[6] Statistics of Income: Corporation Income Tax Returns, U.S. Internal Revenue Service).

[7] 1981 Net total revenue was just under 4 percent of total expenses.

Table 12

Distribution of Reduction in Insurer Receipts ($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
Reduction of benefits	$.455	$1.554	$2.356	$3.326	$3.836	$11.527
Reduction in insurers'profits	.031	.107	.162	.229	.264	.792
Reduction in insurers'administrative costs	.082	.282	.427	.603	.695	2.089
Reduction in Insurer Receipts	$.569	$1.942	$2.945	$4.158	$4.796	$14.409

2. Change in Tax Payments Due to Changes in Profits and Administrative Costs

The bill would reduce insurers' receipts and thus, insurer profits and tax payments. The reduction in insurers' corporate income tax payments (Table 13 below) is estimated to be the marginal tax rate (.46) multiplied by the change in profits (Table 12).

The reduction in administrative costs (shown in Table 12 above) reduces the amount insurers pay for wages. Thus, it reduces individual income and payroll tax payments by insurer employees. We assume that 75 percent of administrative costs are for wages.

The reduction in insurer wage payments has two effects: it reduces employee income tax payments (calculated below using the 26 percent tax rate discussed previously), and it reduces payroll tax payments (calculated below by applying both the percent of wages subject to payroll tax and the payroll tax rates--both from Table 5--to the reduction in wages). Table 13 summarizes the tax effects of the change in insurer revenues due to S.640.

Table 13

Change in Tax Revenue Due to Reduction in Insurer Receipts ($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
Reduction in corporate income tax payments	$.014	$.049	$.074	$.105	$.121	$.364
Reduction in employee income tax payments	.016	.055	.083	.118	.136	.407
Reduction in employee payroll tax payments	.006	.019	.029	.040	.049	.144
Total Insurer Offsets	$.036	$.123	$.187	$.263	$.306	$.916

D. Revenue Offsets--Providers

Although the aggregate drop in income to health care providers will equal the reduction in benefits (Table 13 above) paid by insurers, the revenue impact of this decrease will depend on the federal income tax liabilities of the providers affected. Providers can be divided into two major groups--hospitals and related services, and physicians and related services. Calculation of the tax revenue impact of changes in provider receipts requires determining the changed receipts of each provider group; determining the impact of reduced receipts on profits and wages; and then determining the effect of reduced profits and wages on tax payments.

1. Hospitals and Related Services

Hospitals and related services, which include hospitals, nursing homes, "drugs and sundries" and "eyeglasses and sundries," would bear 12 percent of the reduction in receipts caused by the shift to non-taxable benefits (see Appendix C). The gross margin and marginal tax rate of for-profit providers in this category are assumed to be 5.5 percent and 46 percent, respectively. In billions of dollars, the shift to non-taxable benefits would cause the following reductions in tax payments by this group of providers:

Table 14

Effect on For-Profit Hospitals and Related Services
($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
Reduction in tax payments	$.001	$.005	$.007	$.010	$.012	$.035

These calculations assume that the shift away from health insurance is uniform for all types of health insurance. In fact, it is possible that people would retain some types of coverage in their entirety (e.g., hospitalization) and reduce other types of coverage (e.g., prescriptions and dental care) even more. Such a change would not alter these revenue estimates substantially, but could reduce the bill's ability to control health care costs.

2. Physicians and Related Services

Physicians and related services, which includes physicians, dentists and other professional services, would bear 36.7 percent of the reduction in receipts caused by the shift to non-taxable benefits (see Appendix C). A marginal tax rate of 50 percent is assumed for this group while the reduction in payroll taxes is calculated based on the payroll tax rates and the percentage of wages subject to payroll taxes shown in Table 5. In billions of dollars, the shift to non-taxable benefits would cause the following reductions in income and payroll tax payments by this group of providers.

Table 15

Effect on Physicians and Related Services
($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
Reduction in income tax payments	$.084	$.285	$.432	$.610	$.704	$2.115
Reduction in payroll tax payments	$.015	$.052	$.079	$.110	$.132	$ .387

The following chart summarizes all insurer and provider tax revenue offsets caused by the shift to non-taxable benefits under our assumption of an 8.75 percent annual growth in premiums and a 25 percent shift to non-taxable benefits. Details are provided in Appendix D. Amounts are in billions of dollars.

Table 16

S.640--Insurer and Provider Revenue Offsets, ($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
1. Insurer corporate tax	$.014	$.049	$.074	$.105	$.121	$.364
2. Insurance company employee income taxes	.016	.055	.083	.118	.136	.407
3. Insurance company employee payroll taxes	.006	.019	.029	.040	.049	.144
4. Provider corporate income taxes	.001	.005	.007	.010	.012	.035
5. Physician, etc., income taxes	.084	.285	.432	.610	.704	2.115
6. Physician, etc., payroll taxes	.015	.052	.079	.110	.132	.387
Total Insurer and Provider Offsets	$.136	$.464	$.705	$.994	$1.154	$3.453

E. Aggregate Revenue Impact

Assuming a shift of 25 percent and premium growth of 8.75 percent, our estimate of the 5-year revenue yield of S.640 is $14.2 billion, as compared to $26.5 billion for JCT and $27.4 billion for the Treasury. Alternate assumed values for the premium growth rate, degree of shifting to non-taxable benefits and feedbacks define a range of estimates of $6.5 billion to $25.6 billion. Our range of estimates is presented below:

Table 17

S.640-JCT and Price Waterhouse Revenue Estimates
($ in billions)

	FY84	FY85	FY86	FY87	FY88	Total
JCT estimate	$2.120	$4.077	$5.433	$6.638	$8.273	$26.541
Price Waterhouse estimate:						
High (10 percent shift 12.6 percent premium growth)	$2.073	$3.941	$5.246	$6.358	$7.940	$25.558
Most Likely (25 percent shift, 8.75 percent premium growth)	$1.746	$2.765	$3.094	$3.097	$3.487	$14.189
Low (50 percent shift, 8.75 percent premium growth)	$1.510	$1.825	$1.513	$ .834	$ .786	$6.468

F. Additional Revenue Offsets

Additional offsets to the tax revenue produced by S.640 are difficult to quantify, but their effect on revenue is undeniably negative.

- There are currently 32 states which pattern their tax codes partially or completely after the Internal Revenue Code. Some of them could be expected to tax health benefits if the Federal government did so as well. Since some taxpayers itemize their deductions and since State and local taxes paid are deductible from Federal liability, this would reduce tax revenues.
- Reductions in health insurance would bankrupt some individuals. Since creditors can deduct part of their uncollectible debts, this would reduce tax revenues.
- The tax would impose an administrative burden on employers reducing their profits and corporate income tax payments.
- The incidence of the payroll tax may not be entirely on the employee. In the short run employers may bear the burden of the tax, reducing their profits and corporate income tax payments

Thus, the reduction in tax revenue relative to the JCT and Treasury estimates is likely to be greater than is shown above.

VI. CONCLUSION

We suggest three major changes in the Treasury's and Joint Committee on Taxation's revenue estimates of S.640.

(1) A lower annual growth rate in health plan contributions. Based on historical trends, we find little support for a growth rate of 12.6 percent per annum in private health insurance premiums in a period when inflation rates are projected to average 4 to 5 percent. By using an annual growth rate of 8.75 percent, our 5-year revenue estimates is $7 billion lower than JCT's estimate.

(2) A greater degree of shifting from taxable health benefits to non-taxable benefits. JCT and Treasury assumed that 15 percent of newly taxed health benefits are shifted to non-taxable benefits. Our assumption of a 25 percent shift reduces the 5-year revenue estimate by $2 billion.

(3) The bill's proponents acknowledge that it will reduce insurer revenues. If insurer revenues decline, so will provider revenues. When revenues fall, so will profits and thus, so will tax payments. We estimate that these offsets will reduce 5-year revenues by $3 billion.

Under varying reasonable assumptions for growth in contributions, shifting to non-taxable benefits, and feedback effects, S.640 could yield a 5-year revenue total in a range of between $7 billion and $26 billion. Under our assumptions, as indicated above, we find that S.640 would most likely yield 5-year revenue of $14.2 billion.

APPENDIX A
HISTORICAL DATA ON PRIVATE HEALTH INSURANCE PREMIUMS AND INFLATION

Year	Premiums (in billions)[1]	Percent Increase in Premiums Over Prior Year	Percent Increase in CPI Over Prior Year
1970	$17.1	--	--
1971	19.5	14.2	4.3
1972	22.4	15.1	3.3
1973	24.8	10.8	6.2
1974	27.8	11.9	11.0
1975	32.4	16.7	9.1
1976	38.2	17.9	5.8
1977	44.6	16.8	6.5
1978	49.7	11.3	7.7
1979	55.9	12.5	11.3
1980	63.6	13.7	13.5
1981	73.2	15.0	10.4
		Average 14.2	Average 8.1

Ratio of annual premium increases to annual Consumer Price Index increases: 1.75

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[1] Health Care Financing Review, U.S. Health Care Financing Administration, September 1982.

APPENDIX B

EXCESS CONTRIBUTIONS UNDER ALTERNATIVE ASSUMPTIONS OF HEALTH PLAN GROWTH RATES

(Amounts are in billions)

Annual Growth Rate of Private Health Insurance Premiums	1984	1985	1986	1987	1988
8.75 %	$11.37	$12.94	$14.72	$16.63	$19.18
10 %	$11.75	$13.78	$16.32	$19.36	$22.42
12.6 %	$12.50	$15.66	$19.59	$24.39	$30.48
13%	$12.77	$16.22	$20.51	$25.82	$32.40

Assumes: (1) Monthly "cap" is $70 per single employee and $175 per employee with family in 1984. "Cap" is indexed to the Consumer Price Index.

(2) Annual increase in the Consumer Price Index is 5 percent.

(3) Excess contributions under 12.6 percent annual growth rate are from the Joint Committee on Taxation's calculations.

APPENDIX C

PERSONAL HEALTH CARE EXPENDITURES PAID BY PRIVATE INSURANCE, 1981

Group	Item	$ in Billions		Percent of Total	
A.	1. Not-for-profit hospitals	$34.268	$34.268	51.3	51.3
B.	1. For-profit hospitals	5.121		7.7	
	2. Drugs and drug sundries	2.357		3.5	
	3. Nursing home care	.204		0.3	
	4. Eyeglasses and appliances	.333		0.5	
			8.015		12.0
C.	1. Physicians' services	19.031		28.5	
	2. Dentists	4.346		6.5	
	3. Other professional services	1.113		1.7	
			24.490		36.7
	Total		$66.773		100.0

Source: U.S. Health Care Financing Administration, Health Care Financing Review, September 1982. Source for percent of hospitals operating for profit is U.S. Bureau of the Census, Census of Service Industries, 1977 Geographic Area Series, SC77-A-52 and SC77-A-53.

APPENDIX D

DETAILS OF INSURER AND PROVIDER OFFSETS

($ in billions)

8.75% PREMIUM GROWTH AND 25% SHIFT TO NON-TAXABLE BENEFITS

	FY1984	FY1985	FY1986	FY1987	FY1988	Total
1. Preliminary Revenue Estimate	$1.882	$3.230	$3.799	$4.091	$4.640	$17.642
2. Insurer Revenue Loss Due to shift to non-taxable benefits	.569	1.942	2.945	4.158	4.796	14.409
3. Change in Insurer Profits (#2 x .055)	.031	.107	.162	.229	.264	.792
4. Change in Insurer Tax Payments (#3 x .46)	.014	.049	.074	.105	.121	.364
5. Change in Insurer Administrative Costs (#2 x .145)	.082	.282	.427	.603	.695	2.089
6. Change in Insurance Co. Employee Income Tax Payments (#5 x .75 x .26)	.016	.055	.083	.118	.136	.407
7. Change in Insurance Co. Employee FICA payments (#5 x .75 x FICA rates x Social Security Wage Base)	.006	.019	.029	.041	.049	.144
8. Change in Receipts of For-Profit Hospitals, etc. (#2 x .8 x .12)	.055	.186	.283	.399	.460	1.383
9. Change in Profits for For-Profit Hospitals, etc. (#8 x .055)	.003	.010	.016	.022	.025	.076
10. Change in Tax Payments of For-Profit Hospitals, etc. (#9 x .46)	.001	.005	.007	.010	.012	.035
11. Change in Income of Physicians, et. al. (#2 x .8 x .367)	.167	.570	.855	1.221	1.408	4.230
12. Change in Income Tax Payments by Physicians, et. al. (#11 x .5)	.084	.285	.432	.610	.704	2.115
13. Change in FICA payments by Physicians, et. al. (#11 x FICA rates x Social Security Wage Base)	.015	.052	.079	.110	.132	.387
Total insurer offsets (#4 + #6 + #7)	.036	.123	.187	.263	.306	.916
Total provider offsets (#10 + #12 + #13)	.100	.341	.518	.730	.848	2.538
TOTAL OFFSETS	$ .136	$ .464	$ .705	$.994	$1.154	$3.453

Mr. **Wortley**. I would go to just one more question, Mr. Chairman.

Mr. Schweiker, I understand the complications of taxing all existing life insurance policies and how disastrous that would be for the policyholders and for the companies as well. But suppose we grandfathered in existing policies and started to pick it up with new policies. What effect would that have?

Mr. **Schweiker**. Congressman, first of all, I guess in terms of capital formation and the investments that come from those kind of policies, it would sort of be slow death instead of sudden death. There is no question that the jolt would be spread over a much longer period of time. The effect, though, on the principle would still be the same. It would put ultimately at risk the kind of capital formation and investment that we get from this area. By the same token, it really wouldn't raise much money and I think this is sort of the irony of it, that by doing the grandfathering thing it would almost be the year 2000 before you see any money and then you wouldn't see much money at that. So you put a whole industry at risk, the capital formation at risk, kill a product that's been around for many years and has given much economic protection, and you get no revenue. So it's a little hard for us to understand the logic of that.

Mr. **Wortley**. I think Mr. Jones would like to respond to that, too.

Mr. **Jones**. Yes. Well, I'm not sure I'm directly in response, but I would observe that the chairman correctly challenged what the real motives of the administration and Treasury seem to be, and when you look at the property-casualty situation you would think that they almost want to change the way we do business rather than approach the matter as revenue. So you really do wonder about their questions, and it certainly results in a weakening of the financial structure of the business and our ability to meet the needs for insurance right now and to respond and to be sound, strong companies.

Mr. **Wortley**. I guess what we're saying is if it isn't broke, don't try and fix it. It's working pretty well right now. My time has expired. Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you for those subjective conclusions. [Laughter.]

Ms. Jenckes.

Ms. **Jenckes**. I just have one other observation that I would like to make for the record since I have two Congressmen here from New York. The entire proposal is in the name of fairness. The Treasury estimates right now that the health care tax alone will affect only 30 percent of the American public. However, the tax will be imposed on approximately 100 percent of New Yorkers and 100 percent of Californians, and I don't think you're responsible for either the high cost of health care or are responsible for paying that tax for many other parts of the country.

Chairman **LaFalce**. Now why would it affect 100 percent of New Yorkers and 100 percent of Californians as opposed to——

Ms. **Jenckes**. Because of the higher cost of doing business and the higher cost of health care, higher wages, higher energy costs, higher rent.

Chairman **LaFalce**. You're talking about cost of living. OK.

What about the individuals who would be affected by this limit? Do you have any data on that?

Ms. **Jenckes**. In terms of numbers of——

Chairman **LaFalce**. Not so much numbers of, but wage distribution. What's the average income of the person that would have the limit as proposed by Treasury?

Ms. **Jenckes**. The vast majority of the workers, 80 percent or more of the workers earn less than $25,000, but we do have it broken down and I would like to submit this for the record.

Chairman **LaFalce**. Please do that in overall national aggregate statistics, but do you have it on a regional basis, too?

Ms. **Jenckes**. Yes, we do.

Chairman **LaFalce**. Such as New York and California?

Ms. **Jenckes**. In fact, some of it is highlighted in the paper that I'm going to submit for the record.

Chairman **LaFalce**. Good. Make sure I get that today or tomorrow personally. I would appreciate that.

Now just a few closing questions. I've got a report, Mr. Schweiker, by the Joint Committee on Taxation which states that the insurance industry in 1983 paid an effective tax rate in the United States of 9.9 percent. Now that would seem to me as if your industry has been paying far less than many others in our economy, in part because of the Federal tax subsidies. Any comment on that?

Mr. **Minck**. I think two comments, sir. One, the tax law in 1983 had been established 2 years before as part of a process in which we were going from the 1959 Tax Act to what was eventually established and passed last year and is currently in effect.

There were a number of things that happened that year that would result in depressed taxes in that year. There were slightly higher taxes in the preceding year. But in any event, it's under a tax law that was in existence for only two years and it was looked at as an interim while the Congress was developing the current tax law and, of course, all of the things we have been talking about today have been taxation of the individual policyholder rather than the taxation of the company.

Mr. **Schweiker**. Mr. Chairman, if I may add——

Chairman **LaFalce**. Well, we have been talking about things that go to the taxation of the company, though, too.

Mr. **Schweiker**. Let me just add this, Mr. Chairman, because——

Chairman **LaFalce**. Not with respect to you, but certainly with respect to the casualty business.

Mr. **Schweiker**. It's a relevant question and I think there were a number of miscalculations on several people's parts in terms of what the temporary law would project in income. So it certainly fell far short of what was expected to produce.

This was taken into account when we wrote the new law and the new law is designed to supply significantly more than the temporary law. So the industry acknowledged that targets were not reached and that calculations were not realized from all sides and put forth the new law on the basis that it expected to raise a substantial amount of money beyond the temporary law.

Chairman LaFalce. Let me switch to the property and casualty insurance industry. The GAO report found that your industry has paid a zero effective income tax over the past 10 years. Now do you agree with this; and if you agree with it, how do you account for it, etc.?

Ms. Walters. I don't have the precise numbers in front of me for the past 10 years, but I will note that the Internal Revenue Code, while there are lots of things about it that a lot of us might disagree with and certainly with their proposal, one thing that is very clear is you do not have to pay taxes if you do not earn any money, if you have no income, and certainly in the last 5 or 6 years that's been the problem with the property/casualty industry as a whole, which is why we are in the desperate straits we are in today.

We had underwriting losses in 1980—I have them in front of me beginning in 1980—was $3 billion. In 1984 they increased to $21.3 billion, and it is estimated to be a $23 billion loss in 1985, and these figures translate to, I might add for the latest 2 years, to a total overall operating loss—so it would include income from all sources—there's been a loss. So you don't pay taxes unless you earn income.

Chairman LaFalce. Mr. Hunter, would you care to give us your perspective on my question?

Mr. Hunter. I will refer to Best Advanced Rating report dated yesterday. They have 5 years of experience for property/casualty insurance, 1980 through 1984, during which time there was a $51 billion underwriting loss. However, during that period of time there was a $66 billion net investment income. Income taxes were a negative $2.9 billion.

The return on policyholder surplus was 10 percent. The net cash flow was plus $58 billion.

So there are obviously some very interesting tax rules at play. There was a profit of 10 percent of policy over surplus over that period of time and there was a negative almost $3 billion Federal income tax.

Chairman LaFalce. Having heard all of that, can't we at least agree on the following—that we very clearly have within the United States a complex, but a clearly defined and articulated industrial policy with respect to the insurance industry, and that that industrial policy has been articulated over the years, almost an entire century, through the Tax Code? Doesn't the Tax Code of the United States contain a definite industrial policy for the insurance industry of America, Mr. Hunter?

Mr. Hunter. I have no idea why they built the policy. I can only look at the results.

Chairman LaFalce. Don't you agree that the Tax Code is clearly an explicit industrial policy for the insurance industry, clearly, whether it's good or bad?

Mr. Hunter. All I can say is that it results in little or no taxation, whatever the policy rationale is.

Mr. Jones. Mr. Chairman, speaking just for the property/casualty industry, no.

Chairman LaFalce. There's no industrial policy in the Tax Code with respect to the insurance industry?

Mr. Jones. No.

Chairman **LaFalce**. How can you possibly make that statement, Mr. Jones?

Mr. **Jones**. The portions of the code that put us in the position of not paying some taxes in some cases is not directed toward the insurance industry. We put a substantial amount of our resources into the municipal bond market, the tax-exempt bond market. Now that's not for the insurance industry. That is for the State and municipal entities. Also, it's a broad policy of the Government to allow an 85 percent deduction offset on your dividends and we happen to put a lot of money into equity securities. That was not for the property/casualty insurance industry. It is a broad policy to avoid double taxation on corporate income.

Chairman **LaFalce**. Mr. Schweiker.

Mr. **Schweiker**. Well, my answer would have been unequivocably yes. I believe we have had it. We had it initially for some years back going back to the 1959 act and even before that. We attempted to revise it 2 years ago and it took longer than we thought. We did finally achieve it last year and we really think that's what we have and that's what we would like to give a chance to operate before we revise it one more time.

Chairman **LaFalce**. I think at least Mr. Jones and maybe Mr. Hunter misunderstood where I was heading.

For the past several years I have been trying to point out virtually to everybody in the United States of America that we do have hundreds and thousands of industrial policies in the United States, but we don't have a very good industrial competitiveness strategy. And, in large part, our industrial policies exist within our Tax Code. Very often, I have argued, they have not been well thought out, have been counterproductive, have outlived their usefulness, been uncoordinated, and sometimes they have been outstanding and sometimes they have been excellent. I haven't looked at specific provisions, but I have been trying to fight the ideological purists who just say you can't talk about industrial policy, that's a no-no, that's bad, not realizing that they have industrial policy here in the United States. We always have had and always will have.

The question is, is it direct or indirect, is it through a loan or a loan guarantee, or through a tariff or through the Tax Code or through some other device? How do we coordinate these into some coherent, cohesive strategy for the service sector and the manufacturing sector, for the smokestack industries and the sunrise industries of America? That's what I have been trying to get at.

Now what we have been doing is just putting our head in the sand with respect to virtually all industries by denying that such policies exist. We would be putting our head in the sand if we proceed on this quest for tax reform and tax simplification, if you will excuse those euphemisms, without recognizing that industrial America has been built up over the past century, in large part, on the basis of the Tax Code and that we will cause in the name of reform or simplification some temporary and/or permanent dislocations of unknown quantity and quality. Perhaps we definitely should proceed but perhaps not. We ought to be very careful as to what we are doing before we do it.

Mr. **Jones**. Mr. LaFalce, you're absolutely correct and the problem is it was never thought through at the same time. It was thought through at different times and it is not coordinated and you are correct in that regard.

But I'd like to say simplification is a false goal. One of my closest friends became a very distinguished Federal tax teacher and he used to tell all of his pupils, "If you just started off by saying there would be so much on income, the lawyers could fill volumes of books on what income was." So it's a false goal.

Chairman **LAFALCE**. I want to reiterate what I said earlier—that the Treasury plan is being marketed under the rubric of tax simplification, but since two-thirds of the American taxpayers don't itemize, they have no problem determining what bracket they fall into. We are left with one-third that may or may not get greater simplification. Based upon my analysis of the proposal, it's probably going to be just as complex if enacted, maybe even more so, marginally improved if at all; so that perhaps it has merit, but simplification is not the merit of it.

I am very much attracted to the proposal, let me tell you, but for two principal reasons—the increase in the personal exemption and the increase in the zero bracket amounts. I think that can do more to help bring about the equitable distribution of societal wealth than any other provisions in the Tax Code.

But as I said earlier, the President let the cat out of the bag in Spain yesterday when he said, "What we need in the United States and what we are promoting is a less progressive income tax." That's really what he has wanted since the first day he entered politics 20 or 30 years or so ago. That's what the opponents of the income tax in 1913 argued against. They said, "You're bringing about progressivity here." We said, "Yes"—we—those who preceded me and wanted it. That's the best way to bring about equity.

Reform means change and simplification if you just use it—what I'm interested in is equity in the Tax Code. Maybe one of the best ways to get equity—increases in the zero bracket amount, increases in the personal exemption—is to raise some revenues and, therefore, you have to look at the tax—you call them incentives, I would call them tax expenditures or tax subsidies—and we have to look at yours along with all the other tax expenditure, tax subsidies, tax incentives. They are all the same things depending on who uses them. Hopefully this subcommittee's deliberations will be of some help to the entire Congress if and when it ever decides to consider this issue; hopefully, it will be of some help to the administration. If nothing else, they have been of some help to me. For that, I thank you very, very much.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[The following additional material was submitted for inclusion in the record:]

UNITED STATES GENERAL ACCOUNTING OFFICE
Washington, D. C.

FOR RELEASE
MAY 17, 1985

STATEMENT FOR THE RECORD
BY THE
DIRECTOR, GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE
SUBMITTED TO THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
THE TAXATION OF THE PROPERTY/CASUALTY
INSURANCE INDUSTRY

Mr. Chairman and Members of the Committee:

I am pleased to present our views on the taxation of the property/casualty insurance industry. For the last 6 years GAO has had an active interest in the taxation of the insurance industry. In 1981 we submitted to the Congress a report on the taxation of life insurance companies. On March 25, 1985, we submitted to the Senate Finance Committee another report, Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Insurance Industry, GAO/GGD-85-10.

Your Subcommittee's staff requested that we cover four areas relating to the taxation of the property/casualty industry:

- --our report and its recommendations,
- --the impact of current tax provisions on the industry,
- --the industry's pricing stategies, and
- --a financial overview of the industry.

I will cover each of these areas in turn.

AREAS OF PROPERTY/CASUALTY INSURANCE TAXATION NEEDING CONGRESSIONAL REEXAMINATION

Our report on the taxation of the industry indicated that three areas of the tax code needed the Congress' reexamination. These areas were

- --the deduction currently allowed for loss reserves. The current method of calculating this deduction ignores the time value of money.
- --the practice of currently deducting all of the expenses associated with the sale and renewal of insurance policies. The current method allows these expenses to be deducted before the firm takes into income the associated premiums.

--the protection against loss account, which defers a portion of a mutual company's income to provide a cushion for catastrophic loss. This tax deferral may be based on questionable economic assumptions about property/casualty insurance operations.

Our conclusions and recommendations in each of the three areas studied may be summarized as follows:

First, with respect to the loss reserve deduction, our conclusion was that the present practice of deducting in the tax year the full (undiscounted) amount of future estimated settlement costs overstates the loss reserve deduction. Since the assets underlying loss reserves are invested pending final settlement of claims, the firm actually needs to set aside only that amount which, together with subsequent investment earnings, will total expected subsequent claims. Our recommendation was that the Congress should consider amending the tax code to provide that, in calculating the loss reserve deduction for tax purposes, loss reserves are to be discounted. We further stated that the discount rate should be based on a moving average of each company's pre-tax net return on its investment portfolio.

Second, on the matter of acquisition expenses, we concluded that present practice fails to match expenses and revenues. Currently, the tax code permits all acquisition expenses to be deducted immediately, even though the premiums associated with the acquisition expenses are spread over the life of the contract. In this case our recommendation was that the Congress should consider amending the tax code to provide that acquisition costs be allocated over the life of related contracts to match the pattern of premium payments generated by the contracts.

Third, with respect to the protection against loss account, we concluded that this account may not protect mutual companies against catastrophic losses because the money in the account is not earmarked for that purpose. Thus, if a catastrophic loss were to occur, the account does not necessarily insure the company's ability to satisfy its contract obligations. In this case our recommendation was that the Congress consider whether or not this special tax preference for mutual property/casualty insurance companies should be retained in its present form.

IMPACT OF CURRENT PRACTICE

The current practice of deducting the full amount of an incurred loss, even though it may not be paid for a number of years, does not recognize that the assets underlying loss reserves will earn investment income between the time the deduction is taken and the time the claim is actually paid. The present practice results in the sheltering of investment and other income in the year in which the deduction is taken. Thus, taxable income is effectively reduced. The discounting method proposed by GAO would match against current revenues a current (discounted) estimate of a future loss payment.

In addition to the tax shelter resulting from the non-discounting of loss reserves and the current manner of treating acquisition expenses, property/casualty companies also have available to them many of the same shelters and preferences available to other taxpayers. These include the deduction for income arising from tax-exempt securities and the exclusion of a large portion of the dividends received from domestic corporations. Our report shows that between 1975 and 1982 tax-exempt investment income represented about 40 percent of the gross investment income of all property/casualty companies. The dividends received deduction during this period represented about 20 percent of the gross income of the companies.

While our report did show the extent of the property/casualty company use of the tax exempt and dividends received deductions, we did not make any recommendation for changes in the application of these deductions to property/casualty companies. Our assessment was limited to those provisions of the tax code applicable only to property/casualty companies.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

A property/casualty company derives its income from underwriting gains (the excess of premiums over claims and expenses) and investment gains. Because of investment gains, a property/casualty company can still have net income even though its premiums alone are not large enough to cover claims and expenses. Thus, even though a company has a ratio of claims and expenses to premiums in excess of 100 percent, which normally would indicate the company had suffered an operating loss, it may well have a positive net income because of its investment gains.

For a number of years now we have been hearing the term "cash flow" underwriting. Our understanding of this term is that the companies are willing to use lower premiums to compete for certain business lines, even though they will have ratios of claims and expenses to premiums in excess of 100 percent. The premium shortfall will then be made up by investment income.

While in past years investment gains exceeded underwriting losses by a fairly wide margin, in very recent years the amount of underwriting losses have come very close to the amount of investment gains. For example, in 1984 underwriting losses for the industry were $20.5 billion, while investment income and realized capital gains were $20.8 billion. As the margin has narrowed, some companies have been raising premiums. We may, therefore, expect to see a return to a greater positive margin of investment gains over underwriting losses.

DATA FOR PROPERTY/CASUALTY COMPANIES 1974-1983

Because of the tax-exempt income and dividend exclusion deductions and the current tax treatment accorded loss reserves and acquisition expenses as well as past pricing practices, many property/casualty companies have not paid federal income taxes for a number of years and in fact have qualified for refunds or the ability to carry back or carry forward losses incurred for tax purposes.

To depict the effects of current code provisions on the property/casualty industry, we studied financial data for stock and mutual companies for the 10-year period--1974 to 1983. This data was obtained from Best's Aggregates and Averages. While Bests' reports omit figures for many small and/or new companies, we believe that our figures provide a good representation of the financial results of the property/casualty industry.

In the following tables we show underwriting gains, investment gains, their combined total, as well as the increase in surplus, dividends to stockholders, and their combined total. Federal income taxes are also shown. Underwriting gains and investment gains indicate sources of income, while the increase in surplus and dividends to stockholders indicate the disposition of the income.

Table 1

Stock and Mutual Companies
1974-1983
(in billions of dollars)

Underwriting gains	Investment gains	Total gains	Federal income tax	Percentage of federal income tax to total gains
($27.9)[a]	$109.6[b]	$81.7[c]	$1.5[d]	1.8%

[a] Positive gains in 1977-78; negative in other years
[b] Negative gain in 1974; positive in other years
[c] Negative total in 1974; positive in other years
[d] Negative taxes in 1974-75; 1982-83; positive in other years.

Table 2

Stock and Mutual Companies
1974-1983
(in billions of dollars)

Increase in surplus	Dividends to stockholders	Total	Federal income tax	Percentage of federal income tax to total
$53.6[a]	$21.9	$75.5[a]	$1.5	2.0%

[a] Negative in 1974; positive in other years.

The figures in tables 1 and 2 refer to mutual and stock companies combined. Since dividends to stockholders are applicable only to stock companies, it might be well to show some ratios for stock companies by themselves.

Table 3

Stock Companies Only
1974-1983
(in billions of dollars)

Total gains	Dividends to stockholders	Federal income tax	Percentage of federal income tax to total gains	Percentage of federal income tax to dividends to stockholders
$59.0	$21.9	$0.2	0.3%	0.9%

Another aspect of our 10-year study was to see how the 20 largest companies compared with the other companies. Tables 4 and 5 provide results separately for stock and mutual companies.

Table 4

Stock Companies Only
1974-1983
(in billions of dollars)

	Total gains	Federal income tax	Percentage of federal income tax to total gains
20 largest companies	$19.8	($1.0)	(5.1%)
All other companies	39.2	1.2	3.1%
All companies	59.0	0.2	0.3%

Table 5

Mutual Companies Only
1974-1983
(in billions of dollars)

	Total gains	Federal income tax	Percentage of federal income tax to total gains
20 largest companies	$17.2	$0.9	5.2%
All other companies	5.6	0.4	7.1%
All companies	22.8	1.3	5.7%

The data in these tables show that from 1974-1983 property/casualty companies, in spite of their underwriting losses, had positive net gains yet paid a very small percentage of these gains, 1.8 percent, in federal income taxes. For stock companies, the percentages were lower than for mutual companies; 0.3 percent for stock companies and 5.7 percent for mutual companies.

For large companies, the percentages of federal income taxes paid were lower than for smaller companies. For stocks, the 20 largest companies had an income tax rate of -5.1 percent as compared with 3.1 percent for the smaller companies. For mutuals, the 20 largest companies paid 5.2 percent as compared with 7.1 percent for the smaller companies.

I would like to conclude with the following observation. The financial information we have presented indicates that the property/casualty insurance industry has paid a relatively small share of its net income in federal income taxes in recent years. While we are not in a position to comment on what might be an appropriate federal tax burden for the industry, we do believe that the Congress should carefully consider amending the tax code along the lines suggested in our report. It is not possible to determine whether adoption of our suggested changes to the code would ultimately result in tax revenue enhancement, given the other options available to the industry to shelter income from taxation. However, in our view, the changes would result in a better match of the industry's revenues and expenses and represent a more rational approach to its taxation.

Statement of the Alliance of American Insurers
submitted to
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
May 8, 1985
on the economic impact of "tax reform" proposals
on the property/casualty insurance industry

We appreciate the opportunity to present our views on the economic effects of the Treasury Department's "tax simplification" proposals on the property/casualty insurance industry. The Alliance of American Insurers represents approximately 175 property/casualty insurance companies, writing all lines of property/casualty coverage in all 50 states and the District of Columbia. We are pleased that this subcommittee is looking at the economic effects of tax reform. Our members are not opposed to the concepts of "tax reform" and "tax simplification" as such. Everybody wants a fairer, simpler tax system. The problems arise, however, when the specifics and their impact on our economy are discussed. The specifics that the Treasury and the General Accounting Office have recently proposed would severely harm an industry whose financial strength, currently under considerable strain, is the foundation for the rest of American business. The Treasury and the GAO have not given sufficient attention to this fact, and we hope that you will consider this when the House debates tax reform and tax simplification this year.

Before we discuss the specific Treasury and GAO proposals, we should mention that 1984 was the worst year in the property/casualty industry's history. Underwriting losses overwhelmed investment income, to the tune of a $3 billion loss in operating income and a $2 billion loss in policyholders' surplus, the industry's capital base. Seventeen companies failed, the second-highest number in history. 1985 promises to be only slightly better. It should also be recognized that the P/C industry provides an essential product to American people and American business -- protection against loss. The public policy of insurance regulation has always been to protect policyholders by assuring the solvency of their companies. The strength of the protection our industry provides depends upon its financial strength, and the Treasury and GAO proposals should be judged by their effects on our ability to provide this necessary protection.

I. Treasury proposal

A. "Qualified reserve account" (QRA") discounting

Treasury has believed for several years that property/casualty loss reserves should be discounted to their present values for tax purposes to reflect the time value of money and correct for "overreserving". This is in spite of the fact that authoritative sources believe that the industry is already 10-20% underreserved. Treasury has proposed a new method of discounting, in which insurers would set up so-called "qualified reserve accounts" for each line of business for each policy year (in time, a large multi-line company would have to manage some 70-plus of these QRA's). The economic effect of this proposal is the same as if P/C insurers were taxed on the cash basis and unable to establish reserves at all. Unfortunately, Treasury's theorists have lost touch here with the real world, for the following reasons.

1. QRA is not an income tax, but a tax on loss reserves. Over time it is estimated that QRA will tax 12% of loss reserves per year at the full corporate tax rate. Such a tax has nothing to do with income. Because of this, QRA imposes taxes even in situations where premiums plus pre-tax investment income are only enough to pay losses plus expenses. Thus QRA imposes a tax where there is no income. In other circumstances, QRA imposes a tax of 100% of income. There is simply no justification for this in any income tax proposal.

2. The massive tax liability imposed by QRA would severely harm the P/C industry and the policyholders and claimants who depend upon it. Treasury estimates that QRA would produce approximately $3 billion/yr., while other sources indicate revenue generated could be as much as $4-5 billion/yr. These taxes would come directly from policyholders' surplus -- the equivalent of an insurer's capital -- in an economic climate in which that surplus decreased by $2 billion in 1984. Despite the industry's perilous economic situation, QRA would impose massive taxes because it is a tax on loss reserves and not on income.

3. QRA will cause large premium increases and exacerbate capacity shortages. It is estimated that rates would have to be raised by an average of approximately 11% to make up for the revenue impact of QRA. These increases will harm American insurers in their growing competition with foreign insurers. Because the required price hikes would be much larger in lines where claims are paid over longer periods, the availability of insurance in some of these lines may decrease. This is particularly true, for example, with pollution coverages, where Congress wants to encourage the use of insurance and capacity is already low. Both premium increases and capacity shortages will encourage self insurance, which is poor public policy indeed.

4. QRA shares other flaws with the GAO's discounting proposal, such as the tendency of loss reserve discounting to promote insurer insolvencies. These are discussed in more detail under the GAO's proposal.

B. Other Treasury proposals

The QRA idea is the most important of Treasury's proposed changes, and the most damaging to the industry. But the rest of Treasury's proposals should not be neglected.

1. Elimination of the protection against loss ("PAL") account (also a GAO proposal).

Congress' purpose in creating the PAL account, in essence a deferral of tax on a portion of underwriting income, was to ameliorate the competitive inequity between mutuals and stocks arising from the fact that stock companies can raise capital needed for growth and protection against future catastrophic losses by selling their stock in the capital markets, and mutuals cannot. This purpose has been served. PAL (and the various small mutual deductions, which Treasury would also delete) has helped mutual companies to build the capital necessary to protect them against unanticipated and catastrophic losses. This is especially true for very small companies that write the bulk of their policies in small geographic areas, where local severe storms can indeed cause catastrophic losses. PAL also aids market entry by helping small mutual companies to increase their premium writings without putting unsafe pressures on their policyholders' surplus.

2. Expansion of an extra tax on mutual life companies (the "policyholder dividend differential") to mutual P/C companies.

Treasury believes that mutual companies, who do not pay stock dividends, pay an implicit ownership return in policyholder dividends. This ignores the fact that no property/casualty policyholder buys insurance as an investment. The policyholder buys protection against property and liability losses. Policyholder dividends are generally paid for a specific line of business (largely workers compensation) for specific years in which losses and/or expenses are less than anticipated. There is no investment reutrn to be taxed. The mutual and stock segments of the P/C industry each paid about 50% of the policyholder dividends paid in 1983.

3. Taxation of workers' compensation benefits.

It is unfair to injured workers and their families to tax their benefits, which are at most 66-2/3% of their pre-injury wages, and out of which attorney's fees and other expenses must be paid, at the time that they need them more than ever. It is not fair that, while Treasury would tax compensation benefits, another person with the same injury suffered outside work would pay no tax on any of the tort benefits received. This proposal also increases the costs of American business. States will be strongly pressured by labor and others to increase their benefit levels. If this is done, workers compensation premiums will likely be raised. Since tort plaintiffs are not taxed on personal injury recoveries, attacks on the exclusiveness of the workers compensation will be exacerbated, further increasing the costs of the system. At a time of unprecedented trade deficits, it is hardly advisable to increase the costs of doing business in the United States, yet this is exactly the effect of this proposal.

II. GAO proposals

A. GAO loss reserve discounting

On March 25, 1985, the General Accounting Office released its final report on property/casualty taxation, entitled *Congress Should Consider Changing Federal Income Taxation of the Property/Casualty Industry*. Operating on a purely academic basis, the GAO recommends that loss and loss adjustment expense reserves be discounted using a discount rate based on a five-year moving average of each company's pre-tax investment return (using the taxable year and the prior four years). The proposal is silent as to how companies would determine their claim liquidation rates, except that they should do so using their own data. Reserves for all lines would be discounted. The GAO report does criticize the QRA approach, both because it feels QRA entails more administrative complexity and because QRA makes inadequate provision for reserve strengthening. But the GAO proposal is similarly unwise for the following reasons:

1. State insurance regulators have devised special accounting principles ("statutory accounting") to ensure that property/casualty companies are able to pay their policyholders' and their claimants' losses. One of these principles is that loss reserves must be established at the full amounts that the insurer estimates will be necessary to pay the claims. Statutory accounting has been recognized in the Internal Revenue Code since 1921 as the proper tax accounting method for property/casualty insurers. No valid reason has been shown for a change.

2. Discounting of loss reserves could, over the years, lead to discounting for statutory accounting purposes. This would jeopardize company solvency by forcing companies to understate their liabilitites. Authoritative sources believe that companies are already 10%-20% underreserved.

3. Loss reserves must be as accurate as possible, for they are a P/C company's largest liability and have a great effect on premium rates, the amount of business that an insurer can safely write, and other important business decisions. They are also crucial to a regulator's ability to monitor an insurer's financial health. Discounting requires insurers to know not only how much they must pay, but also what they must pay in and how much investment income they will earn in the interim. Since they can know none of these, for many reasons (inflation, larger jury awards, new sources of legal liability, etc.), but must estimate them, discounting will dangerously reduce reserve accuracy at a time when the industry is already underreserved.

4. GAO discounting will be administratively unworkable. Loss reserves are already difficult for the IRS to audit when only one variable (the ultimate loss) is unknown. GAO discounting will also require the IRS to audit how a company determines its claim payment patterns and its rate of investment return. This will greatly complicate the IRS' job. The companies will also incur large costs because they will have to create complex and expensive new accounting systems to calculate the new variables that must be used. It will require them to keep different sets of books for tax and statutory accounting.

B. Amortization of acquisition expenses

The GAO also recommends that the deduction for policy acquisition expenses, such as agents' commissions and other sales expenses, should be amortized over the lives of the policies to which they relate, rather than deducted immediately, as under current law. This proposal ignores the fact that most taxpayers may deduct sales, marketing and some administrative expenses immediately. There is no reason to discriminate here against the P/C industry. In addition, immediate recognition of acquisition expenses is one of the regulatory protections against insolvency prescribed by state insurance regulation. The Code recognizes that this accounting system is appropriate for tax purposes, given the nature of the insurance business and the public policy reasons for protection of their policyholders. This public policy ought not to be jeopardized for the small amount of revenue that this proposal would bring.

We are pleased that this body has chosen to examine the economic consequences of tax reform and tax simplification. We hope you will encourage the entire Congress to take a long, hard look at these issues, and we hope that you and the rest of the Congress will reject these ill-considered proposals. Only if that is done will we emerge from this process with a tax system that raises adequate revenue while promoting the American economy -- fairly and simply.

STATEMENT OF
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

SUBMITTED TO
ECONOMIC STABILIZATION SUBCOMMITTEE
COMMITTEE ON BANKING
FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
ON THE
IMPACT OF TREASURY TAX SIMPLIFICATION
PROPOSAL ON THE INSURANCE INDUSTRY
MAY 6, 1985

The National Association of Independent Insurers (NAII) opposes the provisions of the first Treasury tax proposal dealing with property/casualty insurance companies, because they would be impractical to apply, create financial chaos, and cause serious harm to the financial stability of the industry. Additionally, the proposals would adversely impact those persons and companies in need of liability insurance.

Since 1921, the Internal Revenue Code has provided that the property/casualty insurance industry is to calculate its taxable income on the basis of statutory accounting, as established by state law and the National Association of Insurance Commissioners. There is no valid reason to change this method of tax accounting at this time, especially in view of the disastrous financial results encountered by the industry in 1983 and 1984, which are predicted to continue in 1985.

NAII represents approximately 500 property and casualty insurance companies. A number of these companies have life and health insurance company affiliates that provide broader financial protection for their policyholders. Although our members are deeply concerned with the Treasury's tax proposal that would significantly change the basis of taxation of property/casualty insurance companies, NAII must, as an important element in the financial institutions community, also express its opposition to certain of the other Treasury provisions that adversely affect policyholders, and employees of its member companies and their affiliates.

NAII strongly opposes a number of the proposed changes in the tax-favored status of employee benefits. NAII is opposed to these provisions since it would cost the government significantly more to provide these vital benefits directly, than to continue to provide tax-favored treatment to those providing the benefits for their employees, or to those receiving such benefits. Because of the rising costs of providing health care, and disability and pension programs, the ability of many people to afford these benefits with after-tax dollars has been seriously impaired. Therefore, there would be significant ~~pressure for~~ the government to provide additional benefits through various direct programs which NAII believes history teaches would be at a much higher cost than through private sector financing. The burden of such additional cost ultimately will fall upon the taxpayer. With government's direct involvement will come not only more costs, but more regulation, and of course, less local and private responsibility and control.

NAII also opposes the taxation of the so-called "inside buildup" in life insurance and annuity policies. A tax on the insured's non-realized increase in the cash surrender value of such policies would reduce the benefits provided, or substantially increase the cost of providing the same benefits. In addition, it would possibly cause many insureds to surrender their policies, thereby foregoing the vital protection such policies provide for the insured, and their dependents. We submit that the most significant impact would fall on older people who have retired and are living on a fixed income.

The key element in the Treasury's proposal adversely affecting property/ casualty insurance companies is the provision dealing with the method of calculation of property/casualty insurance company loss reserves. Loss reserves are essential to meet the claims of those suffering losses covered under an insurance policy, and to assure the fiscal integrity of the property/casualty insurance company.

The method of calculating Loss Reserves should not be altered because:

1. Property and casualty loss reserves are different from life insurance reserves, and other deductions which are discounted for tax purposes. Property and casualty reserves represent economic losses that have already occurred. In actual fact, as well as in economic terms, resources have been consumed. A home has been destroyed; an automobile damaged; an arm has been broken or other physical damage incurred. A current deduction for the full amount of the loss is appropriate. Property and casualty loss reserves are, therefore, fundamentally different from other types of deductions in which discounting of the deduction has been required for tax purposes. For example, life insurance reserves represent a savings for a future event, such as death or retirement. Reserves for mine reclamation and nuclear decommissioning represent provision for future resource consumption, rather than present resource consumption. Accordingly, the rules which govern those items are not relevant to the calculation of property/casualty insurance company loss reserves.

2. Adopting the method of calculation urged by the Treasury Department would seriously undermine the financial integrity of property/casualty insurance companies, impair state solvency regulation, and disrupt the operating framework of the property/casualty insurance industry. The laws of

every state are directed to assuring that adequate funds will be available to pay losses that have already occured by requiring property/casualty insurance companies to create reserves in the full amount necessary to pay those losses. The Treasury's proposals for calculating loss reserves for tax purposes would undercut the conceptual framework requiring companies to reserve for incurred losses in full. As the National Association of Insurance Commissioners has testified, this will seriously impair the ability of state regulators to 1) regulate for solvency, and 2) assure adequate funds to meet claims. Given the serious financial condition the industry faces, having lost approximately $2.0 billion in policyholder surplus in 1984, the worst year in the industry's history, the Treasury proposal raises the specter of significant increases in the number of property/casualty insurance company insolvencies.

3. We submit that the Treasury proposal with respect to loss reserves results in taxing nonexistent income. If the deduction for unpaid, but actually incurred losses, is calculated as Treasury proposes the effect will be to collapse, and tax immediately, the stream of income that is anticipated to be realized in the future. Such calculation will also result in a heavier tax being imposed if the loss payment is delayed, than where the loss is paid immediately, even though the amount of income in the system is the same.

4. The Treasury proposals would disadvantage domestic insurers relative to foreign insurers. Insurance is a highly portable international business. Calculation of reserves in line with the Treasury proposal, with the resultant taxation of future income before it is realized, would substantially increase the cost of domestic insurance. An increased amount of insurance business will be placed with foreign insurers, further eroding the domestic industry's stability and the country's balance of payments.

5. The Treasury's proposal would be an administrative nightmare. Establishing the reasonableness of loss reserves is a perennial source of controversy between taxpayers and the IRS. The Treasury's "Qualified Reserve Account" method would impose a substantial and costly administrative burden on taxpayers, and, we submit, would be a source of endless additional controversy with the IRS.

Another unfortunate provision in the Treasury's proposal relates to "dividends" paid to policyholders by mutual property/casualty insurance companies.

The present policyholder dividend deduction for mutual property/casualty insurance companies should not be limited. The deduction provided to mutual property/casualty insurance companies for such repayments does not provide a competitive advantage over stock companies, and is a proper deduction since it is simply a return of an excess premium. Policyholder dividends are amounts repaid by both stock and mutual property/casualty insurance companies to policyholders as returns of excess premiums.

Another Treasury proposal would eliminate the so-called "Protection Against Loss" (PAL) account presently provided mutual property/casualty insurance companies under the Internal Revenue Code.

The PAL account deduction should not be eliminated. This provision of the Code provides mutual property/casualty insurance companies with an asset cushion from which extraordinary losses can be paid. The PAL account was also created to provide mutual companies with a procedure to raise capital, in view of mutual companies' lack of access to equity capital. The PAL account has served the purpose for which it was created.

If Treasury's proposals are enacted they will further erode the industry's ability to offer insurance protection against economic losses incurred. The industry is not in the financial position to absorb the additional costs that the provisions will impose. Substantial premium increases would come in such socially necessary coverages as workers' compensation and medical malpractice. The increases would likely be substantial. For example, Best's, a respected insurance authority, estimates that the Treasury's Qualified Reserve Account proposal would raise workers' compensation premiums by approximately 15%, and medical malpractice costs by 20-30%. Such increases would have far-reaching consequences for the entire economy.

The NAII appreciates the opportunity to present its views on these vital issues.

STATEMENT SUBMITTED BY THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

namic

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HAROLD W. WALTERS, CAE
President

PROPOSALS TO CHANGE TAX RULES AS THEY APPLY TO PROPERTY AND CASUALTY INSURERS

Former Secretary of the Treasury, Regan, at the suggestion of the President conducted a thorough review of the Internal Revenue Code for the purpose of tax simplification and reform. The package is purportedly "revenue neutral." The Treasury proposal includes four items which directly impact the property and casualty (P/C) insurance industry; of the four, three are applicable to mutuals only. The proposals are as follows:

1. Discounting of loss reserves to reflect time value of money.
2. Elimination of the Protection Against Loss (PAL) account.
3. Elimination of special provisions for small companies.
4. Taxation of mutual P/C dividends to policyholders whether paid or not under a formula tied to stock P/C companies. (Items 2 through 4 apply to mutuals).

We have three basic objections to the proposals:

1. The first proposal deviates from statutory accounting as a basis for taxation and leads to concerns over solvency. Due to the specialized nature of the industry, statutory accounting has been followed for tax purposes since the Revenue Act of 1921.
2. The Treasury is applying Life Industry concepts to the P/C industry.
3. Adoption of the three mutual proposals will not avoid unfair competition, but will create it.

We oppose any change in statutory accounting for tax purposes. We oppose targeting the mutual industry and specifically the three mutual proposals. We oppose any method of discounting reserves. And we are greatly disturbed by the application of life concepts to the P/C industry, since there are distinct differences between the two industries.

Proposal No. 1 – Discounting of Estimates of Unpaid Losses

The Treasury proposals suggest that estimates of unpaid losses are maintained for a period of time and therefore should be discounted to reflect the investment income that is earned during the time held. To allow a 100 percent deduction in the year the loss is incurred is to allow a deduction greater than that which is ultimately paid to the claimants. This, the Treasury Report indicates, is an improper deferral of tax liability. The report notes that in other cases where similar reserves are allowed, discounting is required, citing as an example life insurers. The proposal refers to future losses, while the P/C industry only recognizes losses as they occur. Further, the report suggests this distorts the choice between self insurance and third party insurance, encouraging the purchase of insurance rather than self insuring.

We oppose the discounting of loss reserves because:

1. It would be a violation of statutory accounting.
2. It would affect solvency as defined by state regulation.

-more-

3. It would tax future investment income.

4. It would add to current concerns over the adequacy of existing loss reserves.

5. It ignores the fact that P/C losses have already occurred when the reserve is established as opposed to the life industry where the reserve is established when the policy is written.

6. It would add to the current concern over the ability to provide insurance coverage.

The Treasury Report suggests the way to discount would be the employment of what they call a Qualified Reserve Account (Q.R.A.). This account is predicated on a life insurance concept. Basically, the Qualified Reserve Account would work as follows:

> The initial reserve with respect to a policy will not be permitted to exceed the premiums under that policy reduced by deductible sales and administrative expenses. The reserve, once established will be increased annually by a percentage equal to the after tax rate of return earned by the company in that year, on its investments. This addition to the reserve will be non-deductible. (In effect, this creates additional taxable income). The only increase in the reserve that will be allowed as a deduction will be what they label as a strengthening when it is felt that the reserve itself is insufficient to cover future claims. (This is a life concept). A deduction would be permitted when the claim is paid, less the accumulated amount in the Qualified Reserve Account (which is the initial premium, less the acquisition expenses, plus the annual investment income on that amount added throughout the time that the reserve is held).

The suggested effective date for the new proposals dealing with discounting is for all policies issued on or after January 1, 1986.

We oppose any method of discounting, but we have the following specific objections to Q.R.A.

1. The concept is worse than discounting.

2. It is a life industry concept.

3. The original reserve is limited to the policy premium less acquisition expenses. The absurdity is evident when it is observed that the exposure on every P/C policy is many times the premium. Any limitation is an understatement of losses.

4. It actually results in a disallowance of a deduction for the after tax investment income added annually to the reserves.

5. The deduction when the loss is paid is improperly limited to the excess over the reserve which includes a build up of non-deductible amounts.

6. The effective date of January 1, 1986, applies to new business which ignores the opening reserve values and losses incurred concept.

7. The proposal will bring about a tax on fictional income which will put a P/C company in jeopardy when paying losses in a future year despite the loss carryback provisions.

8. The proposal requires accounting on a policy year basis which is archaic and long ago abandoned by the P/C industry. The cost of maintaining a separate record for tax purposes would be prohibitive.

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9. The schedule on P. 276 of the proposals is inaccurate. The column headed "total net income" ignores significant dividends to policyholders, which represents a return of premium, and unrealized gains and losses. Moreover, it must be noted that the total industry suffered a net loss in excess of $3 billion in 1984.

Proposal No. 2 – Protection Against Loss Account

The Treasury's Report suggests that the continuation of the allowance of a deduction to mutual P/C insurers of additions to the protection against loss (P.A.L.) accounts would be unfair, since the deduction is unnecessary and is in fact unrelated to the measurement of economic income. The Treasury has for some time been concerned about the taxation of what it refers to as "true economic income."

The Treasury Report continues by stating that the PAL account is nothing more than a bookkeeping entry made for tax purposes and a corresponding reserve is not required for statutory purposes and thus it in no way results in assisting financial solvency. The report further states that the existence of the PAL account allows mutual companies to have an unfair competitive advantage as compared to stock companies. The Treasury Report continues that the calculation of the PAL account required an arbitrary distinction between underwriting and investment income. This, the report suggests, increases the complexity of the tax code. (This comment ignores the fact that this distinction is made for statutory accounting purposes and was in effect long before PAL). The suggested effective date for the discontinuance of the PAL account is December 31, 1985 with a five year period to ratably tax any balance in the account.

This is a mutual company proposal only. The PAL account should be maintained for the following reasons:

1. The proposal ignores the fact that the PAL account was originally placed in the law as part of the Revenue Act of 1962 when mutual P/C insurers were first subjected to tax on underwriting income.

2. The rationale was that mutuals needed the ability to defer portions of its taxable income to those years in which it would suffer large losses and, therefore, not have sufficient capital to meet its underwriting needs.

3. It is believed the PAL has served the original purpose and should be allowed to continue to smooth the peaks and valleys of the cycle.

4. Adoption of this proposal will not avoid unfair competition, but will create it.

Proposal No. 3 – Special Tax Exemptions, Rate Reductions and Deductions of Small Mutual Companies

This proposal suggests that the exemption of those companies with gross receipts of less than $150,000 and the reduced tax rate permitted certain companies with low taxable income and the special vanishing deduction of $6,000 allowed those companies with taxable income of less than $1,100,000 all be discontinued.

The Treasury's rationale is that the special tax rules permitted small mutual P/C insurers provides a competitive advantage to those companies as compared to stock companies and larger mutuals. It suggests that the application of these rules requires arbitrary distinctions between underwriting and investment and unnecessarily complicates the tax rules. It, therefore, suggests the repeal of the special tax exemptions, rate reductions and deductions of small mutual companies effective for years beginning on or after January 1, 1986.

This is a small mutual proposal only. These provisions should be continued for the following reasons:

1. This is a direct frontal attack on small business which is not justified.

2. A survey of 477 companies under these categories indicated a tax increase of 140 percent. This increase in relation to net written premiums is equivalent to about a 9 percent tax. (See Attachment A). An increase in operating expenses of this magnitude coupled with the administrative costs proposed to institute discounting and the potential of developing taxable income from dividends to policyholders would drive many of these companies out of business.

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3. Small mutuals were exempt under prior law (before 1963), where gross income did not exceed $75,000.

4. Adoption of this proposal will not avoid unfair competition, but will create it.

Proposal No. 4 – Limitation on Dividends to Policyholders of Mutual Companies

The Treasury Report comments that mutual P/C insurers are currently permitted a full deduction for dividends to policyholders. It then notes that mutual life insurance companies are not permitted a full deduction for dividends to policyholders. It further observes that this limitation has been based on the assumption that mutual policyholders have two capacities – (1) as purchasers of insurance and (2) as owners of the mutual company.

The report indicates that policyholder dividends paid by mutuals are substantially larger than those paid by stock companies. It further indicates that the mutual life limitation provided in the 1984 Act is predicated on the fact that dividends, in part, are distributions of the company's earnings to policyholders in their capacity as owners of the company. The report states that the deduction for dividends by mutual life companies is reduced by an amount that purports to be what should have been returned to policyholders in their capacities as owners, similar to a dividend to stockholders.

The report observes that the full deduction by mutuals of dividends to policyholders results in a competitive disadvantage to stock companies. (This fails to consider the fact that stock P/C companies pay an equal amount of dividends to policyholders).

It continues by stating that this competitive disadvantage was recognized in the 1984 Act altering the life tax formula.

The proposal is that the limitation, effective for years beginning on or after January 1, 1986, be similar to the one provided in the 1984 Life Act for mutual life companies. This limitation, as it applies to life companies, is predicated on what stock life companies pay as dividends to stockholders as a percentage of their surplus. A comparison is then made to surplus of mutuals and this is in effect the determination of what should have been paid to policyholders in their capacity as owners.

This is a mutual company proposal only. We oppose the limitation on dividends to policyholders for the following reasons:

1. This is a life concept.

2. The comparison to the mutual life industry is completely erroneous since the limitation on dividends to these companies was originally included in the 1959 Life Act for the sole purpose that, absent such a limitation, they would have paid less tax under the new law in 1958 as compared to what it paid previously.

3. The continuation of the limitation under the 1984 Life Act was to accomplish the so called segment balance, i.e., the split of life industry tax burden between mutual (55 percent) and stock (45 percent) companies. No similar comparison should be attempted in the case of P/C companies.

4. No such provision was included in the Revenue Act of 1962, which for the first time placed the mutual P/C industry on a total income basis.

5. It is not merely a limitation on dividends to policyholders, but rather is the creation of taxable income. This type of a system must not be applied to the mutual P/C industry, since it would create income where dividends are not paid to policyholders.

6. P/C industry pays dividends as a return of premium. In fact, some mutuals as a matter of company policy do not pay dividends to policyholders, but reduce the price at the time of entering the contract. This practice is called deviation and is a marketing concept.

7. Adoption of this proposal will not avoid unfair competition but will create it.

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Summary

We are against all of the proposals to change the taxation of P/C companies. The proposals are harsh and in addition to being extremely costly to administer, are certainly not "revenue neutral." They could result in competitive disadvantages rather than creating equality.

The P/C industry has just concluded the worst year in its history. It collectively lost approximately $5 billion in 1984, leading to major concerns about solvency and the ability to continue its role as a significant part of the U. S. economy.

We have attached, (Attachment B) a letter written to Vice President Bush in which NAMIC joined as one of the five P/C trade associations evidencing its willingness to cooperate with the Treasury if and when a review of the P/C tax formula is deemed appropriate.

Submitted on behalf of the NAMIC Tax Committee by the Task Force

Ronald D. Allen – Shelter Mutual Insurance Co.
John R. Lanz – Utica Mutual Insurance Co.
Gerald I. Lenrow – Coopers & Lybrand
William W. J. Rooney – American Mutual Insurance Co.
Gerald W. Woodard – Nationwide Insurance Co.

EXHIBIT B

Alliance of American Insurers
American Insurance Association
National Association of Independent Insurers
National Association of Mutual Insurance Companies
Reinsurance Association of America

Reply to: NAII, Attn: L. Beck, Pres
2600 River Road
Des Plaines, Illinois 60018

January 29, 1985

Dear Mr. Vice President:

The companies represented by our five associations account for virtually the entire casualty insurance industry. We are aware of your interest in promoting a New Federalism in this country. We are writing to you to express our concern that proposals contained in the Treasury Department's recent Report to the President on Tax Reform will strike at the heart of state regulation of insurance for solvency.

We are astonished at the Treasury proposals with respect to casualty insurance, not only because they would inevitably emasculate the ability of state insurance regulators to protect against insolvency, but also because they contradict the analytical conclusions reached by the Treasury's Office of Tax Analysis in a joint Industry-Treasury Task Force appointed in 1983 by Mr. Chapoton, Assistant Secretary for Tax Policy, to examine the issue presented by the Treasury's key proposal. The Task Force analysis is only partially complete because activity was suspended while the 1984 legislation was in progress. But the new proposals cannot be squared with that part of the analysis which was completed and on which we had understood everyone was agreed.

The purpose of this letter is to register our concern that the Task Force procedure on which we agreed with the Tax Policy Office was not followed; to reiterate that the new proposals rest upon faulty analysis, as indicated by the Task Force report of the Treasury's own economists; and to request that the Task Force activity be promptly resumed.

The package of proposals for property and casualty companies is, in our view, conceptually wrong. We believe that the proposals should be deleted from any final Administration position on tax reform, and that when Treasury is fully apprised of Industry facts, it will agree.

The key proposal relates to the discounting of casualty loss reserves. The Treasury advanced a similar discounting proposal before the Finance Committee in June, 1983, accompanied by a technical appendix, which adapted to casualty insurance a prior analysis relating to the "time value of money" issues involved in mine reclamation expense. Subsequently, Mr. Chapoton discovered that the Treasury analyst responsible for the mine reclamation analysis, Mr. Seymour Fiekowsky, had never seen the insurance testimony and that Mr. Fiekowsky believed that casualty insurance was an entirely different matter and needed to be analyzed differently. Accordingly, Mr. Chapoton arranged for a task force headed by Mr. Fiekowsky to work with our associations to see whether a correct analysis could be agreed upon. As indicated, that effort has not been completed, but what was done and agreed on cannot be reconciled with the current proposals.

The issue of discounting casualty loss reserves is of critical importance for non-tax reasons. The amount of reserves determines the amount of assets that companies must hold inviolate for policyholders and claimants. Discounting reserves would reduce that amount. It would permit a company to hold aside for policyholders and claimants less than the amount ultimately required to be paid out, on the theory that the company can make up the difference from future income. That is an invitation to financial disaster.

Whether or not discounting is conceptually correct has been a recurring argument in regulatory and accounting contexts, but full reserving has always survived. Insofar as the new Treasury proposal implies that discounting is correct, it threatens--and will, if adopted, destroy--the conceptual defense for full reserving. That would be a victory for those who would like companies to have at company disposal assets now required to be held for policyholders and claimants. The additional tax liability is both serious and wrong, but the implications concerning the ability of state insurance regulators to protect against insolvency are even more critical.

Accordingly, we request that the Treasury's proposal with respect to casualty insurance be deleted from any final Administration proposal on tax reform.

Sincerely,

Alliance of American Insurers
American Insurance Association
National Association of Independent Insurers
National Association of Mutual Insurance Companies
Reinsurance Association of America

The Honorable George Bush
The Vice President of the United States
Old Executive Office Building
Washington, D.C. 20501

NATIONAL INSURANCE
CONSUMER ORGANIZATION

May 14, 1985

Rep. John Lafalce, Chairman
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
2129 Rayburn Building
Washington, D.C. 20515

Re: Taxation of Life Insurers and Their Policyholders

Dear Mr. Chairman:

J. Robert Hunter, president of the National Insurance Consumer Organization (NICO), who testified last week on federal taxation of casualty insurance, asked me to submit a brief statement on the taxation of life insurance companies and their policyholders, with particular emphasis on the life insurance aspects of the Treasury proposal for tax simplification and reform. In addition to being a director of NICO, I am a former insurance commissioner of Vermont and a life insurance actuary (FSA). I have testified several times before the Congress on insurance matters.

First, a few observations on life insurance taxation:

1. The life insurance business enjoys substantial income tax advantages.

2. There are no income tax advantages accruing to buyers of term life insurance policies -- policies providing death protection only without any, or any significant, savings elements.

3. Policies with savings elements -- cash value policies -- derive their income tax advantages from the so-called "tax-free inside build-up," meaning that interest (or other investment earnings) credited to the savings elements is not taxed yearly; is never taxed if the policy is held until death; and is partially tax-free if the policy is surrendered. On surrender, a taxable gain may arise, but its magnitude is not only reduced by sales and administrative charges but is further reduced by aggregate costs of protection; hence, the inside build-up is always at least partially tax-free.

4. To some extent, federal taxation of life insurance companies recovers some of this tax advantage. If the Treasury proposal were to pass, it might be unfair subsequently to recover in federal income taxes on *companies* as much tax as is now collected.

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5. Each state taxes life insurance premiums at least 2%. This premium tax applies to the savings portions of cash value policies; no similar tax applies to other investment media. It would be reasonable for any federal tax reform measure implicitly or explicitly to credit these taxes against federal taxes otherwise required of the industry.

6. Much life insurance is sold as "tax-leveraged" life insurance, meaning that interest deductions on policy loans are permitted at the same time that interest credits inside the policy remain untaxed. This practice, limited only by the weak and unenforceable 4-of-7 rule, is tantamount to deducting interest on loans to purchase tax-free bonds, which is illegal. For what it's worth, a copy of a letter to Senator Dole is attached.

In short, to a significant extent the purchase of cash value life insurance is not only tax-favored but is also a form of tax shelter. We deplore the tax-shelter aspects of life insurance and urge the Congress, at the very least, to eliminate them. This could be done (a) by disallowing interest deductions on life insurance policy loans; (b) by adjusting the policyholder's basis in the contract for purposes of computing taxable gains on surrender by deducting from premiums paid (less dividends not used to buy more insurance) the aggregate costs of protection; and by (c) eliminating the waiver of taxable income at death (as with deferred annuities, the taxable gain at death would be carried forward to the beneficiary). Or, it could be done as the Treasury has proposed.

Whether the tax-deferral aspects of life insurance and deferred annuities should also be removed is a closer question. We have read the Treasury's rationale for doing so and, but for the ignored state premium tax burden on policyholders, it makes good sense. Perhaps a compromise position would be to retain the tax-deferral feature and also retain some form of federal investment income taxation.

Finally, in light of the life insurance trade association's emotional attack on the Treasury's proposal, it may be worth pointing out that if life insurance cash value policies lose some or all of their tax-appeal, buyers may focus more attention on buying adequate term life protection. We question whether public policy is well-served when a family buys $100,000 of tax-leveraged whole life insurance, because that is all it can afford, when a $250,000 term life policy would cost far less in the first few years.

Sincerely,

James H Hunt

James H. Hunt

NATIONAL INSURANCE
CONSUMER ORGANIZATION

October 28, 1983

Sen. Robert Dole
Chairman, Committee of Finance
United States Senate
Washington, D. C.

Re: Life Insurance Tax Act --
limit on policy loan interest

Dear Senator Dole:

I am a former Commissioner of Banking and Insurance for Vermont, a director of the National Insurance Consumer Organization (NICO) and a life insurance actuary. Recently I have been preparing an article on financed life insurance, commonly known as "minimum deposit" life insurance. In general, I am exploring some guidelines for purchasing such contracts: how long must one hold the contract for the tax leverage to work, what taxable gains develop, whether a purchaser is trapped into holding such a contract until death, and so forth. I myself have carried minimum deposit insurance for more than twenty years. With today's high interest rates, the scheme can turn into a bonanza: in effect, the government provides you with free insurance and an annuity to boot after keeping the plan going twenty years or so. Huge taxable gains develop that are completely undisclosed at purchase. I have the impression that in the past these taxable gains have gone unreported by insurance companies and therefore untaxed. I find no redeeming public purpose to minimum deposit life insurance; as you know, it is a variation on borrowing to buy tax-free bonds and deducting the interest, which is illegal.

The life insurance company tax bill that comes to your Committee places a lifetime limit on the amount of tax-deductible policy loan interest of, for example, $500,000 for a couple. This seems excessive to me, but my purpose in writing is to raise some related questions.

At the present time, minimum deposit proposals that I have seen are silent on the particulars of the taxable gain that is building up over the years. I have in front of me a proposal for $100,000 in an excellent company. The proposal contains four pages of figures, none of which illustrates the taxable gain on surrender of the policy, which is easily computed to be 140,000 after thirty years and $404,000 after forty years. The company merely observes in a footnote that, "Income tax consequences on surrender are not considered." Loan interest exceeds $500,000 after forty-one years at age 76. At this point the purchaser is trapped: he can't afford to continue without a tax deduction and he can't surrender because he would have a gigantic tax bill. All of this on a modest sized policy of $100,000, but with an assumed loan rate of 12%. This illustration suggests the following questions:

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(1) Is there any possibility that in exchange for the right to "coin money" at the expense of the federal government the usual right of the states to set rules for disclosure might be over-ridden and companies required in any minimum deposit sales proposals featuring "after-tax" illustrations to state, according to current assumptions governing the illustration, (a) when the policy loan limit will be reached and (b) the taxable gains that develop from time to time?

(2) Whatever the new limits on policy loan deductibility, it is clear that there will be a move toward low policy loan interest rate minimum deposit contracts to avoid the limits. It is the spread between net borrowing cost and internal rate of return that makes the scheme work; thus, a company I know now offers an 8% loan rate contract with an internal rate of return of about 7.5%, so the spread is 3.5% in a 50% tax bracket, which provides a very handsome return on the initial investment. What is to prevent 6% or lower loan rate contracts so that ever larger policies can be written? Although in theory the larger the loan interest the greater the leverage, in practice the [illegible] diminishes slowly as the policy loan rate decreases and there is an offsetting advantage of sharply lower taxable gains. These thoughts lead to the possibility of a rule against below market policy loan rates in a manner somewhat analogous to the provision of the current bill that limits yearly interest.

(3) I am concerned that the large taxable gains building up in minimum deposit policies that have been in force for many years will remain unreported and untaxed despite the TEFRA reporting requirements. The problem is illustrated by this hypothetical situation: A policyholder with a $100,000 policy loan and a $50,000 capital gain surrenders his policy, which has a cash surrender value of $100,500; the net surrender value is $500, which is either de minimus for reporting purposes or, if not, is used to convert the policy to $1,000 of paid-up insurance, thereby causing no surrender to take place, nor will it ever. The $50,000 capital gain goes untaxed, despite a de facto surrender. Is your Committee certain that such a loophole does not still exist? I have a feeling that everyone in the life insurance business knows what constitutes an event triggering the need to report, but all are taking advantage of ambiguities in the law or IRS regulations not to do so.

I hope these thoughts are not entirely too late or stale.

Sincerely,

James H Hunt

James H. Hunt, FSA

THE IMPACT OF TAX SIMPLIFICATION ON THE FINANCIAL SERVICES INDUSTRY

THURSDAY, MAY 9, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met at 10 a.m. in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Vento, Roemer, Levin, Carper, Gordon, McCandless, and Grotberg.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

Today is the fifth in a series of hearings held by the Subcommittee on Economic Stabilization on the sectoral consequences of the Treasury tax simplification plan, and the second on the service sector of our economy. Yesterday we examined the possible impact of the Treasury plan on the insurance industry. Today we will take a look at the banking industry.

Banking industry representatives, unlike the representatives of the other industries that have testified before this subcommittee, appear genuinely ambivalent about the consequences of the Treasury plan for their industry. They seem to believe that lowering the overall corporate tax rate to 33 percent, as proposed in the Treasury plan, would benefit their industry. In addition, they appear uncertain whether interest indexing, also proposed in the Treasury plan, would indeed lower interest rates and help financial institutions.

On the other hand, there are clearly provisions of the Treasury plan which the industry opposes: the elimination of the reserve method of accounting for bad debts; the change in the current treatment of net operating losses of financial institutions to parallel that of other businesses; and the limit placed on the use of the cash method of accounting for small banks.

The banking industry, like every sector of our economy, would be affected both positively and negatively by a simpler, more neutral Tax Code such as proposed in the Treasury plan. Each industry must weigh the pluses and minuses for itself and for the entire economy in assessing the desirability of the so-called tax simplification. It appears that the banking industry, perhaps more than others, has made a genuine effort to take a balanced view of the

Treasury plan. I look forward to hearing the perspective they have to offer us this morning.

We are fortunate to have with us today several distinguished industry representatives: Gordon Martin, chairman of the tax committee of the American Bankers Association; Theo Pitt, vice chairman of the economic affairs committee of the U.S. League of Savings Institutions; and John Tuccillo, vice president and director of research and economics, National Council of Savings Institutions.

I think we will have as our first witness Mr. Gordon Martin, the representative of the American Bankers Association.

May I say it is a special pleasure to have Mr. Martin appear before this subcommittee. At one time he was a resident of the then 36th Congressional District, now the 32d Congressional District that I have the pleasure of serving. His parents still are constituents of mine. I am proud that he has advanced to the chairmanship of the Taxation Committee of the American Bankers Association and am also proud to have him before the subcommittee today.

Mr. Martin, you may proceed. I tell you, Mr. Martin, and the other members of the panel, that I will put the entire text of your remarks in the body of the record. Therefore, you may feel free to either read those remarks or summarize them so long as you can do it all within 10 minutes apiece.

STATEMENT OF GORDON F. MARTIN, CHAIRMAN, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION [ABA], ACCOMPANIED BY CHARLES W. WHEELER, ASSOCIATION TAX COUNSEL

Mr. **Martin**. I am Gordon F. Martin, administrative vice president and director of taxes for Marine Midland Bank. I am testifying here today, however, in my role as chairman of the ABA Taxation Committee. I am accompanied by Charles Wheeler, tax counsel of the American Bankers Association. I would like my entire written statement to appear in the record.

At the outset I want to emphasize that the American Bankers Association supports the general concept of tax reform. However, before the ABA could support a particular tax reform proposal the proposal must be found to meet certain criteria.

First, tax reform must promote simplification of the tax system and thus increase taxpayers' respect for the system.

Second, tax reform should serve to eliminate the underreporting of income. Banks are currently active participants with Government to promote tax compliance. While we are currently doing all we can, we continue to support efforts which will enable the IRS to prevent underreporting in other areas.

Third, and in my estimation of significant importance, tax reform should eliminate the bias against savings and investment. The current Tax Code's structure has made speculation and consumption more attractive than savings. By restoring the incentive to save we can promote noninflationary economic growth through increased capital formation. The resulting investments will reinvigorate American business and industry. As a step toward encouraging savings and investments, the ABA supports the continued expansion of IRA's and believes that their use should be made available on a broad and consistent basis.

Relatedly, tax reform should increase efficiency and incentives for economic growth. In this regard, reduction in the marginal tax rates goes a long way toward stimulating investment and savings, a key ingredient to the entrepreneurial spirit of America.

Finally, tax reform must provide for an orderly transition where disruptions to the marketplace can be minimized and where past economic decisions are not penalized.

We look forward to reviewing the administrations' revised tax reform proposals when they are submitted to Congress to see how they meet the criteria just outlined.

Given our general support for tax reform, as qualified, what should tax reform be for financial institutions? Is there a reason to change the present system or capture additional taxes from the financial industry? In order to answer these questions one must review the role banks currently play in the economy.

Commercial banks are, in general, subject to taxation under the same rules as other taxable corporations. Despite this fact, there seems to persist a belief that banks must benefit from a number of special provisions in the Tax Code. The basis for this belief appears to be the various studies claiming to show that the effective tax rate of banks is very low. However, a closer review of this situation would indicate that the major element reducing a bank's tax liability, namely, the exemption from Federal income tax of interest paid by State and local governments, is directly passed along to those governments. This supports their financial borrowing requirements at a lower cost. Clearly the bank's role is as an intermediary in the advancement of public policy.

Other elements of the Tax Code which ostensibly reduce the tax burden of financial institutions, namely, investment tax credits, depreciation and foreign tax credits, are provisions which are generally available to the entire taxpaying population. And in the instance of investment tax credit and depreciation the benefits of these provisions are passed along to the bank's customer who avails himself of lease financing. Any changes to the provisions we have just mentioned might nominally increase the effective tax rates of banks, but the real economic burden would be on the State and local governments and the businesses that would no longer receive the benefit of lower financing rates.

In addition to looking at the ways the present tax system affects financial institutions, it is also important for us to reflect on other ways banks are bearing their fair share of the burden of defraying the costs of government. This area involves a discussion of the contribution made by banks through excess earnings of the Federal Reserve System.

Under the Monetary Control Act, banks must post reserves with the Federal Reserve System on an interest-free basis in direct ratio to their transaction and short-term savings accounts. The aggregate reserves of the banking system are a critical ingredient to the Federal Reserve System's control over monetary policy. While the purpose is essential, it deprives banks of substantial investments in earning assets. Moreover, the Federal Reserve uses the funds to invest in Government securities, directly generating revenue that is brought into the Treasury as miscellaneous receipts. Although not a direct tax, this represents a financial contribution by the banking industry to the revenues available to pay the direct cost of Government. No other industry makes a parallel financial contribution.

My comments today will focus on the tax deductibility of bad debt reserves. I would also like to refer you to my written testimony where we speak in detail about our support for rate reduction, expansion of IRA's and indexation of interest.

Additionally, my written testimony deals with our opposition to the provisions with regard to the deduction for tax exempt obligation carrying costs, accrual accounting and foreign tax credit provisions. While these are all important items, I would like to make a few additional comments with regard to the foreign tax credit provisions.

Because of the role bank foreign loans play in financing the sales of U.S. commodities and products abroad, a reduction in the availability or utility of the foreign tax credit to commercial banks could not fail to have an adverse impact on U.S. trade, on our balance of payments, and ultimately on domestic employment.

One area where we believe reform is appropriate for financial institutions concerns additions to bad debt reserves. Specifically, the ABA recommends that the reserve method of calculating bad debts be retained for commercial banks and that facts and circumstances of each particular bank's loan portfolio determine the appropriate level of the reserve for tax purposes.

Since 1921 all taxpayers have been allowed deductions for reasonable additions to reserves for bad debts. The reserve method was originally proposed as a result of numerous conflicts over the arbitrary determinations on the part of taxpayers and the IRS as to when a debt was worthless and should be written off. Throughout the intervening years Treasury and the Congress have modified the application of reserve accounting for financial institutions. However, at no time was reserve accounting abandoned.

The alternative to allowing reserve accounting would be to deduct bad debts when all the indices necessary to charge a loan off have occurred. However, we believe the reserve method is a better way of measuring economic reality and reflects the fact that within a loan portfolio, loans become economically worthless well before all of the criteria necessary to charge that particular loan off have occurred. Not to recognize this fact in a tax system would distort the reality and result in taxes not being properly paid in the correct period.

The facts and circumstances of each particular bank's loan portfolio is the determinent to conclude the adequacy of its reserve. Management of each bank has an absolute responsibility to its shareholders, as reviewed by the bank's outside auditor and the regulatory agency supervising it, to determine an adequate allowance for a loan loss reserve. We believe that the review which management conducts of the facts and circumstances surrounding its loan portfolio and the adequacy of its reserve for loan losses is an honest and accurate attempt to properly match income and expense and would not result in a distortion of income over any extended period of time.

Furthermore, not only do we feel that the facts and circumstances methodology as reflected in book tax conformity is the most correct way of determining economic income for taxation, but we also believe this methodology would be consistent with bank regulatory policies and would further the goal of achieving a safe and sound banking system.

An additional point which needs to be considered is, in looking at the tax treatment of bad debts in other countries, the overriding majority of countries allow the reserve methods of accounting. In a 1983 study prepared by Peat Marwick Mitchell & Co., 27 countries were reviewed as to the allowable tax treatment for bad debts. Of the countries reviewed, only Australia and Venezuela limit deductions to specific chargeoffs.

Therefore, by requiring the specific chargeoff method in the United States, the U.S. tax system will be out of line with most of the country's major trading partners.

Mr. Chairman, this represents our views on the Treasury's tax reform proposal. We are looking forward to seeing what changes will be made when the President announces his plans.

As I indicated above, the American Bankers Association does support the concept of tax reform. Tax reform, however, should recognize the traditional conduit role played by banks in the tax system. This role has been and will continue to be important in ensuring that tax benefits, such as the tax exemption of State and local obligations, are available to all those for whom they were intended.

Finally, Mr. Chairman, I hope that the broadening of the tax base is not used as an excuse to eliminate the reserve method of accounting for bad debts. The continued use of the reserve method is necessary to accurately compute a bank's taxable income.

Again, Mr. Chairman, we appreciate the opportunity to testify on this issue. We would be more than happy to supply any additional information needed or to answer any questions that you may have.

Thank you.

Chairman LAFALCE. Thank you very much, Mr. Martin, for an excellent presentation.

[Mr. Martin's prepared statement, on behalf of the American Bankers Association [ABA], follows:]

STATEMENT OF GORDON F. MARTIN ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am Gordon F. Martin, the Chairman of the Taxation Committee of the American Bankers Association. I am an Administrative Vice President and the Director of Taxes for Marine Midland Bank. The American Bankers Association is the national trade and professional association for America's Full Service Banks. The combined assets of its member banks represent approximately 95 percent of the industry's total assets. I would like to thank the Subcommittee for this opportunity to testify.

Last year, in anticipation of the current activity in the area of tax reform, the ABA selected a task force of economists and tax executives from a cross-section of our membership. This task force was charged with the detailed examination of the various tax reform proposals, and with assessment of the impact of such proposals on banks and the economy as a whole. This group studied the Bradley-Gephardt, Kemp-Kasten, Roth-Moore, VAT, and Brookings proposals. Since December, our attention has been focused on the proposal made by the Treasury Department.

The task force examined the theoretical underpinnings of the reform proposals, as well as the technical applications of individual items. Before addressing the latter, I would like to spend some time discussing our conclusions as to what tax reform should accomplish, and also the treatment and role of financial institutions under the current system.

At the outset, I want to emphasize that the American Bankers Association supports the concept of tax reform.

This endorsement of tax reform, however, is general and not indicative of support for any of the proposals we have examined to date. Before the ABA could subscribe to any particular tax reform proposal, the proposal must be found to meet certain criteria.

First, any tax reform proposal should promote simplification of the tax system. It should increase taxpayers' respect for the system by furthering the perception of the tax laws as a simple, fair, and equitable arrangement. We recognize that the tax code will always be complex. We are concerned, however, with the current perception that the complexity benefits the rich.

Second, tax reform should serve to eliminate the underreporting of income. Banks currently do more than any other non-governmental entity to promote tax compliance. We have consistently and conscientiously assisted the IRS in its attempts to identify hidden income through reporting on interest and dividends, foreclosures and abandonments, mortgage interest received, and back-up withholding to ensure the full reporting of income. While we are currently doing all we can, we continue to support efforts which will enable the IRS to prevent underreporting in other areas.

Third, tax reform should reduce the bias against savings and investment. A re-defined tax system should encourage people to save rather than consume. The current tax code's bias against investment has made speculation and consumption more attractive than savings. This creates personal financial hardship and undermines the capital base necessary for American industry to modernize and improve productivity. By restoring the incentive to save, we can promote non-inflationary economic growth through an increase in capital formation. The resulting increase in investment will reinvigorate American business and industry. With a greater pool of capital available, the interest rates could fall, reducing the federal budget deficit.

Fourth, tax reform **MUST** provide for an orderly transition. It is absolutely imperative that disruptions to the marketplace be kept to a minimum, that past economic decisions not be penalized, and that business be provided with a clear, concise, and constant set of rules by which they can move smoothly toward the new system over a period of time, and plan for future growth and expansion of economic activity.

And fifth, tax reform should increase efficiency and incentives for economic growth. The tax code can be a useful mechanism for stimulating economic growth. This is clearly seen in the positive effects of the mortgage interest deduction. Such incentive, however, must be limited to clearly defined and generally recognized public goals. If they are not, the free market will not be allowed to direct investment to its most productive use.

If any tax reform initiative is to be enacted, it should address all of the above concerns. In addition, the ABA believes that change should be phased in to prevent severe market shocks. We would oppose abrupt, massive changes in the tax code where the economic effects of the changes cannot be measured.

We are particularly concerned over the ability to assess the economic effects of the Treasury proposal--or any of the others--on the total economy. While we find several of the individual ideas in that proposal worthwhile, it is extremely difficult to assess the overall economic effects of such sweeping, system-wide tax reforms. The proposed changes are likely to have unforeseen effects which neither econometric studies nor informed judgement can detect. The changes are too many and too varied for the econometric models to accurately evaluate. Because of this problem, we would urge the Congress to be cautious in making changes of such magnitude.

Before beginning my discussion of the specific changes affecting banking as proposed in the Treasury plan, I would like to discuss the role banks play under the current system. An understanding of that role is necessary to fully appreciate the effects of tax reform on financial corporations.

Commercial banks are, in general, subject to taxation under the same rules as other taxable corporations. There seems to persist, however, a belief that banks must benefit from a number of "special" provisions in the Tax Code. The basis for this belief appears to be the various studies claiming to show that the effective tax rate of banks is very low. An examination of the tax law for those features that are important in studies of effective tax rates reveals that, by and large, "special provisions" or "tax preferences" are not involved. Instead, the single most important factor in reducing the Federal income taxes paid by banks is the exemption from Federal income tax of interest paid by state and local governments on their obligations. Another large component of the reduction for major institutions is the credit allowed for foreign taxes imposed by other countries on income earned by the taxpayer in those countries. A third large component is the combined effect of the investment tax credit and depreciation deductions from equipment leasing operations. None of the tax reducing effects of these provisions of the Federal tax law is attributable to the enjoyment of a special provision by banks.

The more appropriate question is not what is the effective tax rate for banks, but whether banks are bearing their fair share of the burden of defraying the costs of government. The answer to that question necessarily involves a discussion of the contribution made by banks through excess earnings of the Federal Reserve system as well as the reduced rates paid by state and local governments on their borrowings.

Under the Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221), all banks and other depository institutions must now post reserves with the Federal Reserve System on an interest-free basis in direct ratio to their transaction accounts and nonpersonal time deposits. The reserves held by the Federal Reserve System are then invested primarily in government securities. While this is not thought of as a tax,--because it directly generates revenue that is brought into the Treasury as miscellaneous receipts--it clearly represents a financial contribution by the banking industry to the revenues available to pay the direct costs of government. No other industry makes a parallel financial contribution. When the effective tax rate of banks is recalculated to reflect the earnings of Treasury on the reserves provided to the Federal Reserve System and by using a tax equivalent analysis of municipal bond income, they increase dramatically. (A survey conducted by the Bank Administration Institute on 1983 income using the adjustment discussed above shows an effective tax rate of 43 percent.)

As you can see, the current tax code for the most part treats banks as any other corporate taxpayer. By purchasing tax-exempt bonds and engaging in leasing transactions, banks are merely fulfilling the role Congress has encouraged them to perform, that of financial intermediary, a conduit through which tax benefits flow to other taxpayers. Any changes to the provisions we have just mentioned might nominally increase the effective tax rate of banks, but the real economic burden would be on the state and local governments and the businesses that would no longer be able to purchase capital assets.

The one provision in the Tax Code that might be labled a "special provision" is Section 585 which sets out the rules by which banks calculate their loan loss reserve. While some have claimed that this provided banks with an artificially high deduction in the past, that clearly is no longer the case. Many banks, from the largest to the smallest, are currently limited to deducting the debts that were charged-off during the year. These banks maintain a reserve but the "special provision" applicable to banks prevents them from adding to the reserve the losses that are inherent in their loan portfolios but not yet charged off. Other corporations are able to use a facts and circumstances test which would, we believe, allow a significantly higher tax reserve level than banks are allowed under current law. Even in the past, however, the loan loss reserve was never a major component of the reduction of Federal income taxes for banking.

With all of this in mind, let us now turn to a few of the changes proposed by the Regan Treasury. My comments today are not in any particular order and will be mainly limited to income tax issues having a direct effect on banking. We would be happy to comment at another time on other items more directly affecting bank customers and employees including our concerns over the proposed changes to the trust and estate and gift tax areas.

RATE REDUCTION

Corporate tax rates currently are graduated from 15 to 40 percent for the first $100,000 of taxable income (those rates are phased out for corporation's with taxable income over $1 million). All other corporate taxable income is subject to a 46 percent rate. Under the Treasury proposal, the overall corporate rate would be reduced to 33 percent effective for tax years beginning on or after July 1, 1986. In addition, a phased-in repeal of the graduated rate structure would result in a flat 33 percent rate by 1987. The corporate minimum tax also would be repealed effective January 1, 1990.

The ABA supports the reduction in marginal tax rates proposed by the Treasury plan. High tax rates reduce the incentive to work, save, and invest. One of the most important goals of tax reform must be to reduce the bias against savings and capital formation. A series of steps including reduction in marginal rates, expansion of IRAs (see below) and broadening of the tax base, would move the tax system toward this objective. The lower rates should reduce the impact of taxes on investment decisions.

We are concerned, however, that the loss of graduated rates could increase the taxes of many small businesses, including small community banks. It is also clear that lowered rates will not fully offset the loss of other deductions and credits, thereby increasing the overall tax burden on corporations. In spite of these deficiencies, the ABA generally supports the proposed rate reductions.

IRAs

The one item I would like to mention today which does not directly relate to banking's own tax liability is the proposed increase in the maximum IRA deduction.

Under current law an individual generally is permitted to deduct annual contributions to an IRA of 100 percent of compensation or $2,000 whichever is less. Married individuals each receiving compensation during the year may make separate IRA contributions to their IRAs and claim a $4,000 deduction on their joint tax return. Special "spousal" IRA limits provide that if a married individual's spouse earns no compensation during the year the individual may deduct annual IRA contributions up to the lesser of 100 percent of compensation or $2,250. The spousal IRA is not available if the "non-working" spouse has any amount of earned compensation.

The Treasury proposal would increase the IRA dollar limits for individuals from $2,000 to $2,500. Of possibly greater significance is the increase in the spousal IRA limits. The proposal would permit a non-working spouse to take into account his or her working spouse's compensation (less the deductible IRA contribution made by the working spouse) in determining the non-working spouse's deduction limit. Therefore, a married couple with aggregate compensation of $5,000 or more would be entitled to the same $5,000 IRA deductible contribution ($2,500 a piece) regardless of how much compensation was earned by either spouse. In so doing the importance of the economic contributions made by "non-working" spouses will be recognized.

The ABA believes that the tax benefits associated with IRAs were intended to encourage individuals to make adequate provisions for their retirement security. In fact, Congress' growing awareness that a large number of the nation's workers would face retirement with inadequate levels of savings led it to enact, as part of ERTA, a significant expansion of IRA eligibility in order to promote greater retirement income security for all workers. Savings for the purpose of retirement also contributes to the formation of investment capital needed for economic growth.

The ABA supports the continued expansion of IRAs and believes their use should not only be encouraged but made available on a broad and consistent basis. We further support the proposed IRA changes as a step toward reducing the bias in our tax system against savings and investments.

INTEREST INDEXATION

The Treasury proposal provides that beginning January 1, 1989, a portion of interest income would be non-taxable and interest expense non-deductible. For banks, the general effect of the "interest indexation" provision is to exclude from taxable income the percentage of net interest which represents the annual inflation rate. Net borrowers would no longer be entitled to a similar percentage of their interest deduction.

We view the proposal to index interest as part of a series of indexation provisions intended to remove the effects of inflation from the income tax system. While it is clearly necessary to apply inflation adjustments to all forms of investment to prevent distortion in economic decision making, we are uncertain if these adjustments will ease or worsen inflationary pressures. We are also uncertain as to the overall economic consequences of the general indexing proposals and of interest indexing in particular.

For instance, it seems clear that interest indexing will bring interest rates down but we are unable to determine whether the drop will be sufficient to leave borrowers, depositors, or both, better, worse, or the same as they would have been if interest indexing had not been implemented. Nor can we determine the relative cost of financing through debt instruments versus financing through equity. We recognize, however, that any lowering of interest rates will help deficit reduction efforts by reducing the Government's interest costs.

The principle behind inflation indexing is to remove the positive and negative effects of inflation from the income tax system. For debt instruments, the increase in the basis of a lender's assets, because of inflation, must be matched by an equal decrease in the basis of the borrower's liability for the adjustment to work properly. To accomplish this the adjustments must be made on the same method for both assets and liabilities. The Treasury proposal, as currently written would accomplish that by adjusting all net interest income or expense by the same inflation factor. If, however, the net interest income of a bank is not adjusted for inflation, or the adjustment is made on the basis of the banks' assets and liabilities, it appears that the total inflation adjusted income of the depositors and the bank would be greater than the inflation-adjusted costs of the borrowers. We could not support such a result nor do we believe that it matches the principles annunciated in the Treasury report.

If it is determined that the positive benefits of indexing the tax code, particularly interest rate reduction, require enactment of interest indexing, we believe the only feasible method is the one Treasury has already proposed. The reduction in bank tax liability that would result should be passed through to the depositors and borrowers.

ELIMINATION OF RESERVE METHOD OF ACCOUNTING

Since 1921 all taxpayers have been allowed deductions for reasonable additions to reserves for bad debts. The reserve method was originally proposed as a result of numerous conflicts over the arbitrary determinations on the part of taxpayers and the Internal Revenue Service as to when a debt was worthless and should be written off. Beginning in 1947, the Internal Revenue Service tried to provide some certainty to banks as to what would be considered a reasonable addition to the reserve for bad debts. Mimeograph 6209, 1947-2 C.B. 26 provided a formula in which the maximum reserve was based on a 20 year moving average, including the current year, of total net charge-offs to total loans. In 1954, the IRS supplemented this mimeograph with Revenue Ruling 54-148, 1954-1, C.B. 60 which provided that a bank could choose to compute its reserve using an average experience factor based on any 20 consecutive years after 1927.

By 1965, the IRS was again reexamining the formula and issued Revenue Ruling 65-92, 1965-1 C.B. 12. This ruling provided a uniform reserve ceiling of 2.4 percent of loans outstanding, with certain exceptions. As an alternative to the percentage method a bank was allowed to compute its reserve using an experience factor based on a six year moving average.

Congress codified the IRS rulings for the first time in the Tax Reform Act of 1969. In the belief that banks enjoyed more favorable bad debt reserves than most taxpayers, new Section 585 of the Internal Revenue Code provided that the percentage method be phased out completely by December 31, 1987.

The Treasury proposal would repeal Section 166(c) of the Internal Revenue Code, which allows a taxpayer to deduct business bad debts by using the reserve method of accounting. This includes repeal of Section 585 which dictates how a commercial bank must compute its annual reserve addition. All taxpayers would be required to use the specific charge-off method.

One of the reasons the Treasury gives for proposing the change to the specific charge-off method is that the "...current tax system encourages lenders to make risky loans". This is analogous to saying a lender will risk losing one dollar on a bad loan in order to get thirty-three cents in tax benefits. If business decisions were actually made on this basis, every business in this country would go bankrupt.

The Treasury also stated that "...the lower effective tax rate resulting from excess bad debt deductions subsidizes loans from depository institutions and enables them to offer loans at artificially low rates". It should be noted that for the most part loan interest rates are based on market conditions and the cost of funds to the institution although the credit worthiness of a customer is also considered. In addition, banks have sometimes been unfairly accused of keeping interest rates on loans artificially high even though the rates are determined by the marketplace. Now the Treasury is saying the rates are artificially low and implies that interest rates should be raised. This seems inconsistent with the Federal policy of trying to keep interest rates down.

In light of current economic conditions, bank regulatory agencies are encouraging banks to increase their loan loss provisions in order to diminish the risk of severe economic reversals from the cumulative effects of non-performing loans due to business failures. Adequate reserves are necessary to ensure the safety and soundness of the banking system. Other taxpayers are allowed tax deductions for their normal business expenses. Since banks are required to maintain adequate reserves as part of their business operations, these expenses should also be allowed as tax deductions. The tax system should support this as a Federal policy goal.

In looking at the tax treatment of bad debts in other countries, the overriding majority of countries allow the reserve method of accounting. In a 1983 study prepared by Peat Marwick Mitchell & Co., twenty seven countries were reviewed as to the allowable tax treatment for bad debts. Of the countries reviewed, only Australia and Venezuela limit the deduction to specific charge-offs. Therefore by requiring the specific charge-off method in the U.S. the U.S. tax system will be out of line with most of the country's major trading partners.

Over the years the IRS tried to find a formula for computing a reasonable addition to the reserve for bad debts. Experience has shown that these fixed formulas distorted appropriate deductions over a period of time. The Treasury Department is now proposing that we go back to laws in effect prior to 1921 in that only specific net charge-offs be allowed as deductions. This idea does not appear to be any better as a solution now than it was then.

The basic problem with all of these methods is that there is no way to determine the exact portion of a loan portfolio that will be charged-off.

Allowing a reserve based on the present value of anticipated net charge-offs is also not a practical solution. The difficulty inherent in determining the portions of a loan portfolio that are bad is compounded if you also must determine when they will go bad. It also represents a significant departure from generally accepted accounting principles as applied to a bank's financial statement.

It would seem that a reasonable alternative is book-tax conformity. This is not an open ended invitation to banks to decrease their tax liability. The primary duty of bank management is to maximize earnings. At a 33 percent marginal tax rate, bank management would not be interested in artificially reducing earnings by 1 dollar to get a 33 cent tax benefit. Book-tax conformity in fact should more closely approximate the discounted present value method than any other reserve formula. The pressure on banks to maximize earnings will cause their management to be very reluctant to include marginally bad loans in the computation of the reserve addition.

DEDUCTION FOR TAX-EXEMPT OBLIGATIONS CARRYING COSTS

With certain exceptions not pertinent here, the Internal Revenue Code provides that interest earned on state and local obligations is exempt from Federal income tax. The tax-exempt income derived from investment in these assets is the largest single factor in reducing the nominal effective rate of Federal income tax for banks. It should be noted, however, that banks earn a lower rate of interest on these obligations. If the banks used those same funds to purchase taxable securities, the amount of Federal taxes paid would be higher but we doubt that the after tax rate of return would be any higher.

Banks purchase these obligations for a number of reasons that have little to do with the tax-exempt nature of the income from the investment. In many communities, particularly those with either no bond rating or an inferior rating, the banks of the community provide the only continuous, reliable source of financing for the local government. In other words, if the banks of the community would not agree to take a substantial portion of the obligations, where would they be sold--and at what price?

Bear in mind here also that a substantial portion of the tax-exempt obligations issued by state and local governments are not long term bonds but rather revenue anticipation notes and other short-term obligations used to cover temporary shortfalls of cash when payments, including municipal payrolls, become due before periodic tax receipts have been received.

In addition to purchasing a certain number of these tax-exempt obligations in order to meet their responsibilities as good corporate citizens of their communities, banks purchase state and local obligations to assure themselves liquidity and to meet pledging requirements for public deposits in excess of insurance limits.

Approximately 35 states, and many local governments, require banks to secure public deposits in whole or in part by bonds issued by the state or local government involved, Federal securities, or similar high quality forms of collateral.

Clearly, the traditional role of commercial banking in providing financing to state and local governments is not a tax preference enjoyed by banks. In addition, Section 103 combined with Section 265(2) confers a positive benefit on state and local governments through the intermediation of banks. They permit banks to carry out their role as financial depositories of public funds in compliance with the requirements of state laws requiring collateral for large public deposits in an economically efficient manner.

Under current law, all taxpayers, including banks, are disallowed a deduction for interest on debt directly incurred to purchase or carry tax-exempt obligations. However, based on various court decisions and IRS rulings, it has been stated that deposits accepted in the normal course of business, are not debt incurred to purchase or carry tax-exempt securities. This, however, is only a presumption and where the IRS can show a direct linkage between borrowing and the purchase of the tax-exempt securities the issue of the disallowance of interest expense could be raised under Section 265(2).

In spite of the lack of any tie between accepting deposits from local governments and purchasing their bonds, banks are currently denied twenty percent of their interest deduction allocable to the purchase or carrying of tax-exempt obligations acquired after 1982. The allocable portion is presumed to be the ratio of tax-exempt assets to total assets. Under the Treasury proposal, banks would be denied a deduction for 100 percent of their interest charges allocable to the purchase or carrying of tax-exempt obligations. The pro rata presumption would be irrefutable. This would apply to all obligations acquired after December 31, 1985. The current 20 percent disallowance would continue to apply to obligations acquired between January 1, 1983 and December 31, 1985. The ABA opposes this proposed change. The change puts banks at a decided disadvantage when compared to other taxpayers since a direct link between borrowing and the purchase of tax-exempt securities is not the criteria used to determine the deductibility of interest expense.

The purchase of tax-exempt obligations is not linked to deposit-taking activities of banks. These two functions are separate activities, related only in that they represent the two halves of banking-borrowing and lending. Without borrowing, there could be no lending; without lending there would be no reason to borrow. Banks borrow from those who have extra funds and lend to those who need funds.

If Congress does intend to change the banking industry's role as intermediaries in the municipal security market, the ABA believes the proposed denial of the deduction of interest to carry tax-exempt bonds should apply only to tax-exempt bonds issued after a given date. (The proposal now calls for the denial to apply to all tax-exempt bonds acquired after a given date.) This change is consistent with Treasury's expressed desire to protect the tax treatment of past transactions, in that banks purchased tax-exempt bonds expecting to be able to trade the bonds with other banks. Applying the denial of the deduction to all tax-exempt bonds acquired after a given date could thus have a negative impact on the value of the banking industry's existing portfolios.

ACCRUAL METHOD ACCOUNTING

The Treasury proposal would require a taxpayer to switch from the cash method of accounting to the accrual method of accounting for a trade or business effective January 1, 1986, unless the business: 1) has annual average gross receipts of $5 million or less and 2) no other method of accounting has been used to report income or loss in any other financial report.

The adjustment to affect the change would be computed by taking the difference between the previously unreported accrued income and accrued expenses as of December 31, 1985. This amount would be added to or deducted from taxable income over a period not to exceed six years.

Requiring banks to report on the accrual basis does not close loopholes nor broaden the tax base. The proposed requirement also would operate unfairly in that all small businesses are not affected. Many banks have gross receipts under $5 million but all banks are now required to use the accrual method for regulatory reporting purposes. The Treasury apparently feels that such taxpayers will find it simple to convert to the use of the accrual method for income tax purposes. This attitude fails to recognize the numerous differences between the accrual accounting rules for financial statements and those for income taxes. For example, the regulatory accrual accounting rules, which in this instance are also used for financial statements, require banks to stop accruing interest on loans that are 90 days behind in paying interest while the IRS does not recognize any arbitrary cut-off.

In addition to the differences between accrual rules for financial statements and income taxes, there are currently many provisions in the Internal Revenue Code which are based on the cash method; for example, reporting gains on the installment method and taxing prepaid income before it is earned.

The cash method of accounting has been accepted as "clearly reflecting income" over the years from 1913 to the present for businesses without inventories as long as the method is used on a consistent basis from year to year. Since the primary source of a financial institution's income is derived from loans providing for the monthly payment of interest, the cash basis method clearly reflects income on an annual basis. Therefore, we do not believe it is necessary for financial institutions to be required to use the accrual method of accounting.

CHANGES TO FOREIGN TAX CREDIT PROVISIONS

Like other U.S. taxpayers, banks that engage in international activities are subject to foreign taxes on income produced from such activities and are also subject to U.S. income tax on the same income. The foreign tax credit is the tax mechanism by which relief is obtained from the double taxation that would otherwise occur.

Current law entitles U.S. taxpayers to take a credit against U. S. taxes for taxes paid to foreign countries on income earned in those countries. Credits are used on an overall basis; that is, credits from high foreign tax jurisdictions may be used to offset U.S. taxes on income from low foreign tax jurisdictions. Credits are not used to reduce U.S. tax on U.S. income. Under the Treasury proposal, credits available on foreign income would be determined on a per country basis. Excess credits from one foreign country could not be used to offset U.S. taxes due on income from another country. Losses could offset income in other countries, subject to recapture rules.

Foreign lending has become increasingly competitive in recent years. Foreign banks, especially those from strong-currency countries, are a major factor in dollar lending abroad. Up to now, U.S. banks have welcomed the increased competition--although admittedly with mixed feelings--as a sign of the health of the international banking system. As increased competition has narrowed profit margins for foreign lending, the foreign tax credit has become increasingly significant. In fact, if the foreign tax credit were not available, U.S. banks would have to increase interest charges in order to maintain an adequate return. Competition from other banks will not permit such pricing. The increased tax cost would put U.S. banks at a competitive disadvantage with foreign banks, whose costs would not be similarly increased, and might well force U.S. banks out of important overseas markets. Because of the role foreign loans play in financing the sales of United States commodities and products abroad, a reduction in the availability or utility of the foreign tax credit to commercial banks could not fail to have an adverse impact on U.S. trade, on our balance of payments, and even on domestic employment.

The Treasury proposal to move to a per country limitation seems to be based primarily on the belief that the drop in the U.S. corporate tax rate will cause corporations to rush to invest in low tax countries. We do not believe this assertion is correct for American corporations in general and it is clearly incorrect for American banks. A loan is made because someone has a need to borrow. Banks cannot create a need to borrow in residents of tax haven countries merely to take advantage of lower U.S. tax rates. In fact, tax haven countries generally have small domestic economies with no ability to absorb large investments. Instead, the effect of the Treasury proposal will be to limit lending to high tax countries. This will likely mean less involvement by U.S. banks in the international financial markets and a corresponding decline in U.S. international competitiveness and balance of trade. The per country limitation would also be extremely cumbersome and complex to apply. All foreign income would have to be traced to the country where the loan was made.

This would be particularly difficult for the banking industry because of the conduct of its business through a worldwide network of banks. For all of these reasons, the ABA opposes this change.

CONCLUSION

Mr. Chairman, this represents our views on the Treasury's Tax Reform proposal. We are looking forward to seeing what changes will be made when the President announces his plans. As I indicated above, the American Bankers Association does support the concept of tax reform. Tax reform, however, should recognize the traditional conduit role played by banks in the tax system. This role has been and will continue to be important in ensuring that tax benefits, such as the tax exemption of state and local obligations, are available to all those for whom they were intended. Finally, Mr. Chairman, I hope that the broadening of the tax base is not used as an excuse to eliminate the reserve method of accounting for bad debts. The continued use of the reserve method is necessary to accurately compute a bank's taxable income.

Again, Mr. Chairman, we appreciate the opportunity to testify on this issue. We would be more than happy to supply any additional information needed or to answer any questions that you may have.

Chairman LAFALCE. We will now hear from Mr. John Tuccillo, the National Council of Savings Institutions representative.

STATEMENT OF JOHN A. TUCCILLO, VICE PRESIDENT AND DIRECTOR OF RESEARCH AND ECONOMICS, THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. TUCCILLO. Mr. Chairman and members of the subcommittee, thank you for the opportunity of appearing today on behalf of the National Council of Savings Institutions. As you noted, I am vice president and director of research and economics at the National Council. Prior to joining the council I was on the economics faculty at Georgetown University and the senior staff of the Urban Institute. In both those positions I had the opportunity to conduct a number of research studies in the tax area.

I am the coauthor of the most comprehensive study of the taxation of thrift institutions and the author of a number of papers dealing with the taxation of housing and the life insurance industry. So it is from this background that I am testifying today.

The revision of the Tax Code that is now under study in the administration and on the Hill is a complicated matter that can have extensive consequences for the economic health of the country. We at the council have been giving the issue much thought and study. We fielded two tax surveys of our members; council staff have prepared issue papers on the proposals currently in the public arena; we have discussed the topic with congressional leaders and Treasury officials; and we devoted a significant portion of our annual government affairs conference to debating the notion of tax reform and its consequences for savings institutions.

The final result of this effort is that our membership has determined that it is in its interest to support tax reform and tax simplification. Because tax law has grown so complicated and because it is biasing economic behavior, we feel that if structured properly overall tax reform with its attendant lower rates and broader base could be beneficial to the economy in general and thrift institutions in particular by increasing tax compliance and stimulating savings.

We are looking for a system that will balance the needs of equity and efficiency, one that will guide economic behavior rather than force individual and corporate taxpayers into devoting an inordinate amount of resources to tax planning.

You will hear from many groups in the course of these hearings and other hearings held by other committees in the Congress. Let me speak from the viewpoint of the thrift industry and discuss three issues that we would like to see resolved in any final reform measure. Since we are looking, at least for the next couple of weeks or so, at the Treasury proposals of last November, my remarks will be in the context of those proposals.

The first issue I want to deal with is the tradeoff for thrifts between the elimination of the special treatment for the buildup of loss reserves that they now enjoy against a reduction in the corporate marginal tax rate schedule.

As you know, thrifts meeting certain asset criteria, basically 82 percent of portfolio in qualifying assets for savings and loans, 72 percent for savings banks, can deduct against taxable income a certain portion of their receipts as a reserve against bad debts. This deduction, which reaches a maximum of 40 percent, effectively reduces the tax rate for those institutions using it to about 28 percent. Some of this is picked up again since the excess bad debt deductions are subject to the minimum corporate tax on preference items, so that the effective rate for thrift institutions who use the percentage of income deduction method amounts to about 31 percent. While this is below the statutory maximum rate of 46 percent, it is still a relatively large tax bite.

We think that the elimination of the percentage of income method for loan loss reserves can be beneficial to the thrift industry, provided that the marginal corporate rate does not exceed the 33 percent suggested in the Treasury proposals. In this way thrifts can use the powers granted to them under the Garn-St Germain legislation of 1982 without incurring signifcantly higher tax bills. We believe that the use of these powers in a moderate and judicious manner is essential to the restructuring that will restore the health of the thrift industry and allow savings institutions to remain the backbone of the Nation's housing finance system.

The importance of the bad debt allowance as a prime tool for reducing tax burdens has trapped the thrifts into what is essentially a single investment portfolio that has proven unprofitable. The tradeoff of this preference for a lower corporate tax rate will allow savings institutions to make their investment decisions on economic and financial rather than on tax grounds. The result, we feel, will be a much stronger industry which is better able to serve America's homeowners and potential homeowners.

The second issue deals with the recapture of excess loan loss deductions. The current Treasury plan calls for the recapture of loan loss deductions up to the amount that would have been claimed under the system used by commercial banks. Under current accounting rules related to deferred Federal tax liabilities and under rules being considered by the Financial Accounting Standards Board, this recapture would have a significantly negative impact on the balance sheets of savings institution. At a time when thrift capital levels are extremely low and when the deposit insurance agencies are pressuring the industry to build up its reserves and its capital, such an impact would be verging on disaster.

But this practical effect is subordinate to the question of equity. To enforce recapture on the industry now would be to change the rules of the game not during the play of the game, but actually after the game was over.

Thrift institutions used the bad debt allowance and invested almost solely in residential mortgages. There was never a hint of recapture in either the initial legislation, its subsequent amendments or its administration. The minimum tax on preference items served as a recapture function. To enforce recapture now is a rewriting of history that is more worthy of Orwell's "1984" than our own 1985.

The final issue I wish to mention today is that of the net operating loss carryover. Thrift institutions have been dealt with somewhat differently from other corporations with regard to the smoothing out of losses that occur in the course of business. Virtually all corporations are allowed to carry losses back 3 years and forward 15 years; thrifts currently have a 10-year carry back and a 5-year carryforward.

The battering the thrift institutions have taken over the past 8 years because of volatile interest rates has been cushioned to a degree by the long carrybacks which the industry has been allowed. But now a great many of our institutions have exhausted their allowed period and cannot fit their accumulated losses into the remainder of their allotted carryforward period. This is particularly true for those thrifts that have acquired through merger weak institutions with substantial losses.

The industry has a tremendous need to restructure and to attract new capital. One way of accomplishing both these ends is the extension to thrifts of the carryforward provisions afforded other corporations. Clearly, this extension accompanied by a retention of the thrift carryback period would be an ideal change for the industry. But if this is not to be, care must be taken in drafting effective transition rules to avoid penalizing those thrifts who can still use the carryback option.

There are a number of other concerns that are detailed in my written statement and which we feel should be included in any tax simplification package in order to make that package acceptable to the thrift industry. For the most part, we are in strong sympathy with the Treasury approach as well as those taken by your congressional colleagues in both Houses and on both sides of the aisle. We are quite interested in seeing the new proposals that Treasury will announce in the next 2 weeks.

Finally, Mr. Chairman, we commend you for holding these hearings. Tax reform is an important enough issue to demand as full a hearing as possible in a variety of forums.

Thank you.

Chairman LaFalce. Thank you very much, Mr. Tuccillo.

[Mr. Tuccillo's prepared statement, on behalf of the National Council of Savings Institutions, follows:]

TESTIMONY OF
JOHN A. TUCCILLO
ON BEHALF OF
THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS
BEFORE THE
HOUSE SUBCOMMITTEE ON ECONOMIC STABILIZATION
HOUSE BANKING COMMITTEE
ON
THE IMPACT OF THE TREASURY TAX SIMPLIFICATION PLAN
ON THE FINANCIAL SERVICES INDUSTRY

May 9,1985

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear here today on behalf of the National Council of Savings Institutions. My name is John A. Tuccillo and I am Vice President and Director of Research and Economics of the National Council of Savings Institutions. I was previously on the Economics faculty at Georgetown University and the Senior Staff of the Urban Institute. During that time I conducted a variety of research projects in the tax area, including the only comprehensive study of the taxation of thrifts ever done, and several extensive analyses of life insurance industry taxation.

The National Council of Savings Institutions was formed a year and a half ago with the consolidation of the National Association of Mutual Savings Banks and the National Savings and Loan League. The Council represents approximately 600 savings institutions with over $400 billion in assets.

Mr. Chairman, I commend you for holding this hearing to review the impact of the Treasury Department's tax reform proposals on various industries. The revision of the tax code is indeed a complicated matter that can have extensive implications for economic development in this country. We at the National Council have spent a great deal of time and effort over the past few months assessing the impact of the Treasury Plan on our members. The final result is that our membership has determined that it is in its interest to support tax reform and simplification. We do have some important caveats that need to be addressed which I will discuss later.

The National Council did not arrive at this endorsement of tax reform easily. The issues received considerable study by our staff and our members. In the past year we have surveyed our membership twice on tax issues. The first survey related to use of net operating loss carryover exclusively and the second survey attempted to determine the exact tax status of our membership. These surveys allowed us to focus on major issues of concern to our members in developing policy alternatives. Finally, tax reform and simplification was the primary topic discussed and voted on at our Government Affairs Conference in early March of this year. It was the vote of this Conference which directed the staff of the Council to work to resolve identified problems, but to do so in the context of support for ultimate tax reform. In other words, we are approaching the Treasury proposal and other tax reform proposals with a positive attitude.

The members of the National Council feel that current tax law has become extremely complicated and that overall tax reform with consequent lower rates and base broadening could be beneficial to the economy in general and to thrift institutions as well if it is structured properly.

Before we endorse specific tax reforms, however, we have some important caveats that need to be addressed which include the following:

- The corporate tax rate should drop to 33% or below
- Bad debt deduction changes should not be retroactive.

Recapture existing (or even part of existing) bad debt reserves must be dropped

- Net operating loss carryforwards should be available to thrift institutions on the same extended basis as to other corporations
- Cash basis accounting should continue to be available to corporate taxpayers

TREASURY PLAN PROVISIONS RELATING TO SAVINGS INSTITUTIONS

There are a number of provisions in the Treasury Plan that will affect the taxation of savings institutions. I will now discuss the primary issues and our thoughts concerning the impact of the proposals on the taxation of savings institutions.

BAD DEBT RESERVES

The primary tax code provision benefiting thrifts relates to sections of the law that allow deductibility of reserves for bad debts. Under current Internal Revenue Code (IRC) Section 593, savings institutions are granted a special bad debt deduction known as the percentage of taxable income method. Under this method savings institutions are allowed a deduction for addition to loan loss reserves for qualifying real property loans equal to 40 percent of taxable income. There are several limitations on this deduction, the foremost of which is a requirement that 82% (72% for a mutual savings bank) of an institution's assets be in specified, housing related assets. The level of the bad debt deduction allowed drops below 40% as the percentage of assets invested in these areas is reduced. The special bad debt deduction is not allowed to be taken if investment in specified target assets drops below 60% of assets. In addition, savings institutions can use the percentage of loans reserve method available to commercial banks and the modified experience method. These special bad debt deductions are subject to corporate preference cutbacks which drop the value by 20%.

The Treasury Department Tax Simplification Proposal would repeal all of the special rules for bad debt deduction available to thrift institutions. The Plan would require that bad debt losses be deducted only as they occur under a specific charge off method. In addition, the Treasury proposal would require recapture of existing reserves in income over a ten year period.

If corporate tax rates are dropped to at least the 33 percent level suggested in the Treasury Plan, and, if certain other provisions are included in the Plan, the repeal of the special bad debt deduction for thrifts should be able to be accommodated by the thrift industry. Because of the continued cutbacks in the bad debt deduction levels through preference limitations, minimum tax provisions and limitations on other tax benefits available, savings institutions that have taxable income are paying at a marginal tax rate of approximately 31%. Given these tax rates our members believe that the ability to make investment choices based on economic rather than tax choices could provide added flexibility that fits with deregulation of the banking statutes that has already taken place. We would, however, support establishment of tax provisions which would recognize the need for businesses, including savings institutions, to establish some reserve for bad debt.

Along with the corporate.tax rate, our major concern with the bad debt repeal as outlined in the Treasury Plan relates to the part of the proposal requiring recapture of existing reserves. This proposal would have an adverse impact on the savings industry's net worth and continuing efforts to recapitalize. It is an especially cumbersome proposal at a time when insurance regulators (FDIC and FSLIC) are requiring increased capital and tighter net worth standards. The recapture proposal runs counter to current trends to require greater reserves.

It appears that recapture would have an extremely adverse effect on the financial statements of savings institutions under current rules relating to deferred federal tax liabilities and under anticipated rules to be set by the Financial Accounting Standards Board (FASB) for accounting for income taxes. If the fears of the industry are correct, recapture and the consequent financial statement treatment required would effectively wipe out substantial portions of an institutions net worth.

Given these severe consequences, we believe that it is imperative that there be no recapture of existing accumulated bad debt reserves whether it be a partial or full recapture.

Since the Secretary of the Treasury and the chairmen of the tax-writing committees have issued statements indicating that the tax reform proposals will not be retroactive in nature, we hope this provision will be dropped in subsequent versions of the Plan.

Net Operating Loss Carryover

Congress has granted a Net Operating Loss (NOL) carryback/carryforward to smooth out taxable business income for those companies whose income widely fluctuates from year to year. The NOL deduction provides additional operating income and cash flow in severe loss years through NOL carryback refund claims. It also provides a cushion in subsequent years when the loss company is struggling to return to profitability and financial viability through NOL carryforwards.

Most companies have an NOL carryback of 3 years and an NOL carryforward of 15 years. (The carryover was increased from 7 to 15 years in the Economic Recovery Tax Act of 1981). Thrift institutions have a 10-year carryback and a 5-year carryforward.

Traditionally, due to the nature of their business and because of reductions in allowances for bad debt reserves, financial institutions have operated under a longer total carryover period and with a longer carryback period than other businesses. The NOL carryback has provided thrift institutions with a needed cash flow and income cushion against the high level of losses during the past several years. In fact, it may have helped a number to remain viable.

The Treasury Tax Reform Plan would move financial institutions to the same carryover basis as other taxpayers - 3 years back and 15 years forward. The carryforward period granted under this proposal could be quite beneficial to savings institutions if existing losses can be covered in the carryforward provision. The magnitude of the losses experienced by thrift institutions from 1979-1982 has caused many institutions to use the entire 10-year carryback and move into the 5-year loss carryforward. However, unless profits continue to grow or grow at a faster rate than is now evident, many of these institutions will have NOLs that will expire unused during the next 2-5 year period. This is particularly true for those institutions which, in cooperation with FSLIC or FDIC, acquired failing institutions with substantial losses through mergers.

In the uncertain interest environment facing thrift institutions and because of the need for these institutions to have every opportunity to restructure, it is essential that there be an extension in the carryforward provisions of the Code for existing net operating losses of thrift institutions.

Finally, any change in the carryback provision should be accomplished under generous transition rules so as to avoid penalizing those institutions who still have the carryback option. The solution of course is to retain the 10 year carryback since it was granted to financial institutions to compensate for extraordinary bad debts at a time when the other bad debt reserve provisions were reduced. Since the Treasury Plan proposes to repeal the special thrift bad debt deduction, the extended carryback would help compensate for its loss.

CASH METHOD OF ACCOUNTING FOR TAX PURPOSES

The Treasury Tax Reform Plan proposes to limit the use of the cash method of accounting for tax purposes. Taxpayers would be required to switch to an accrual basis for tax purposes unless the business has average gross receipts of $5 million or less. Even businesses with $5 million or less in annual gross receipts would be required to use accrual accounting for tax purposes if it is used for any other purpose (such as financial statement, credit purposes, etc...).

This proposal would have a substantial effect on financial institutions which are by a large majority cash basis taxpayers. Even though the proposal includes a transition rule to allow adjustments to be spread over a period of six years, its impact is substantial. It adds to the complexity of the tax code by removing a simple, straightforward method of tax accounting. It creates uncertainty at a time when stability in the rules is needed. It would accelerate the payment of income tax on income whose funds are not yet actually received. It is an especially onerous step to take at the same time as elimination of favorable tax treatment of bad debt reserves.

Cash accounting accurately reflects income for tax purposes and reflects a method of taxation based on the ability to pay. Therefore, we find little reason to add to the complexity of the Code by abolishing this method of accounting, especially in conjunction with the repeal of the bad debt deduction for thrifts.

REPEAL OF REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFTS

Special rules enacted in 1981 permit the acquisition of a financially troubled thrift institution to qualify as a tax-free reorganization under current law. In addition, present law allows payments by the FSLIC to a thrift institution under these circumstances to be excluded from taxable income. The Treasury Tax Reform Proposal would repeal these statutes.

The present law was enacted in 1981 at the request of the FSLIC to provide the optimum circumstances to deal with the need to assist a number of surviving institutions which agreed to merge or acquire weak or failing institutions. Given the current concern over the long term viability of the FSLIC and the need to provide solutions for other thrifts weakened by the economic circumstances of the early 1980's, we question the need for or wisdom of immediate repeal of this law. Given the continuing problem institutions, it would be wiser to continue this provision and provide a sunset date in the future. In fact, it should be made clear by the federal government that funds under federal assistance programs should not be subject to state or local taxation either.

Additionally, it would appear to us that, as a matter of necessity and equality that identical treatment should be extended to thrift institutions insured by FDIC. There appears to be no reason to treat the two deposit insuring agencies and assistance given by them differently. Finally, the date of repeal should grandfather future assistance promised under agreements already negotiated. These agreements were structured based on the expectation that the assistance would be tax free. If the assistance were to be taxable it would change the economic value of the agreement.

INCREASE IN DEDUCTIBLE CONTRIBUTIONS FOR INDIVIDUAL RETIREMENT ACCOUNTS

The Treasury Tax Reform Plan proposes to increase the deductible for contributions in Individual Retirement Accounts (IRA's) to $2,500 from current levels of $2,000 per year. This proposal would be beneficial to savings institutions because it would increase the goal of long-term savings.

The IRA has been a very good savings account for thrift institutions. Traditionally we have attracted a large percentage of these accounts and they fit well with our members' mortgage lending orientation. Given the lack of other savings incentives in the tax code, we would strongly support retention of this provision in any tax reform plan.

DEDUCTIBILITY OF INTEREST EXPENSE TO CARRY TAX-EXEMPT SECURITIES

Under current law, financial institutions have been allowed to invest in tax-exempt securities without losing their deductions for interest paid on deposits and short-term obligations. Since 1982 however, the amounts invested in tax-exempt securities have been subject to the corporate tax preference cutback of 20%. The Treasury Tax Reform Plan would further restrict this deduction.

Our tax survey shows that this provision would substantially affect a number of our members. Investment in tax-exempt securities contributed a substantial amount of income to some of our members, particularly savings banks. We have no doubt that our institutions will restructure their investments toward higher yielding taxable securities if the deduction attributable to interest on tax-exempts is repealed. We do, however, have concerns about the effect of this action on the value of tax-exempt securities currently held and would urge reconsideration of the repeal or, at a minimum, transition rules to protect our members' investment.

TREATMENT OF INTEREST INCOME AND EXPENSE

The Treasury Tax Reform Plan has a variety of provisions that affect how individuals account for interest income and expense. First, the plan would retain the deductibility of interest incurred to carry a home mortgage on a primary home. This is, of course, an absolutely necessary provision from our viewpoint. If we are to continue to be a nation of homeowners, the deductibility of interest on home mortgages must continue.

Our members were concerned, however, about the proposal to restrict deductibility of interest for second homes and other consumer interest. While such a proposal may be good for savings, our members expressed concern about its effect on the economy as a whole.

In addition, the Treasury Tax Reform Plan would provide for the indexation of interest income and expense. In general, this could benefit financial institutions which should have more interest income than expense. An especially attractive feature would be (if the claims of Treasury and others are correct) reduction in general interest rates. Our members are concerned, however, about the effect of indexation on simplification efforts and that such a step would remove the discipline necessary to control inflation in our economy.

The bottom line is that Council members would require further information on how indexation would work. Further, since we are informed this is one of the most vulnerable parts of the Treasury proposal, we have not prepared extensive comments on this proposal today.

SUMMARY

The provisions we have described today are the primary ones of concern to savings institutions. Obviously, depreciation, deduction of state and local taxes, fringe benefit taxation and a host of other provisions affect our members as corporate taxpayers. We have not devoted any comment on these provisions today but have tried to focus on the provisions we regard as most important to thrifts.

If we have success at achieving some of the modifications discussed today - particularly those relating to the Bad Debt Deduction, NOL carryforward and cash basis accounting, thrift institutions can prosper under the Treasury Tax Reform Proposals and we will be able to support such a plan.

We hope that you in the Congress will consider our comments as you review the Treasury Tax Plan and others which have come before you. I will be pleased to answer any questions you may have.

Chairman LaFalce. We will now hear from Mr. Theo Pitt, the vice chairman of the economic affairs committee of the U.S. League of Savings Institutions.

Mr. Pitt.

STATEMENT OF THEO H. PITT, JR., VICE CHAIRMAN, ECONOMIC AFFAIRS COMMITTEE, U.S. LEAGUE OF SAVINGS INSTITUTIONS, PRESIDENT, HOME SAVINGS AND LOAN ASSOCIATION, ROCKY MOUNT, NC

Mr. Pitt. Mr. Chairman and members of the subcommittee, my name is Theo Pitt from Rocky Mount, NC. I appear today on behalf of the U.S. League of Savings Institutions and its 3,500 member savings and loan associations and savings banks members.

The league appreciates this opportunity to discuss the provisions of the Treasury Department's tax simplification and reform plan which was published last November. We are anxiously awaiting, as I am sure you are, the official administration tax request to the Congress, which I am told is expected later this month.

Though we are very interested in the plan as it affects savers, borrowers, homeowners, and the entire real estate sector of the economy, I want to focus today on the provisions directly affecting our industry as a corporate taxpayer.

The fundamental change for our institutions under the Treasury proposal would be the repeal of our basic section 593 tax treatment. The Treasury plan would tax our institutions as it does corporations generally. Section 593 has been a fixture of the tax laws for many years as part of the congressional policy to assure the availability of home mortgage credit. In brief, 593 permits our specialized institutions to allocate income to bad debt reserves as long as we meet a qualifying assets test. The allocations are deducted in calculating taxable income for corporate tax purposes.

Because of successive tax reductions in the tax acts of 1962 and again in 1969 in the percentage of taxable income which may be allocated to our bad debt reserves, and the subsequent disallowances of portions of this preference category in 1982 and again in 1984, our current tax treatment permits a 32 percent bad debt deduction.

Since savings institutions, because of the specialized investment authorities, make very little use of other corporate tax incentives, such as the investment tax credit in which we have a unique limitation, and accelerated cost recovery or such provisions as the foreign tax credit, our current effective tax rate is 31⅓ percent. This is much higher than the effective rates which apply to our depository institution competitors and higher than companies in, for example, the manufacturing and the mining sectors of our corporate economy.

As you know, the Treasury's November plan proposed to tax corporations generally at a 33-percent rate, virtually the equivalent of our current tax liability. Recent press reports suggest that this may be revised upward to 35 percent. Thus, our league has approached the emerging administration proposal with an open mind but at the same time with our eyes wide open to the potential inequities some of the details of the Treasury's proposal may have for us.

Obviously, any acceptable tradeoff depends for us on what the corporate rate turns out to be when the administration sends its overall plan over to the Hill. If the corporate rates are subsequently increased above 33 percent, then savings institutions, which, as I am sure you are aware, remain in a very fragile condition, could be completely exposed to a higher tax liability, further delaying our recovery from the recent economic doldrums.

In addition to applying the general corporate rate to our industry, the Treasury also proposed in November to recapture a portion of our accumulated bad debt reserve into taxable income over a 10-year period. We estimate that approximately $5 billion could be exposed to this recapture, which at a 33-percent rate would mean an additional tax liability of approximately $1.7 billion spread over the next 10 years. But significantly, for accounting purposes our institutions would have an immediate hit to our net worth, since we would probably have to make an immediate transfer from net worth to a deferred tax account. That, coming on top of a new flat corporate tax, would constitute a double hit against our industry, and that is clearly unfair, in our opinion.

Not only that, but it would severely retard our ability to rebuild our capital positions, and it would pose new problems for the Federal Savings and Loan Insurance Corporation and the FDIC.

We think it is unfair to recapture reserves created from assets priced in reliance on earlier tax rules and in compliance with the specialized economic role that our industry has performed over the years. And we would note that there is no similar recapture proposed for corporations using other tax incentives, such as the investment tax rate. The Treasury recapture proposal is unfair and it is totally unacceptable to us.

In another important area the Treasury has proposed to terminate the separate net operating loss carryback/carryforward treatment for banks and savings institutions, and would place depositories on the same footing with other corporations. This is generally a beneficial change since depositories are at a disadvantage compared to their corporate brethren. Here again, however, it is important to permit a suitable transition to a new net operating loss treatment.

My written statement sets forth a phase-in on page 10 which would provide for an equitable adjustment, we feel.

We would also urge the Congress to reject the Treasury's November proposal to eliminate two special code sections adopted in 1981 to help the FSLIC attract supervisory merger candidates for troubled institutions and to treat as tax free any FSLIC assistance. At this point Treasury has even cast doubt on the tax treatment of the net worth certificate program developed by your parent Banking Committee.

I have appreciated this opportunity to share with your distinguished subcommittee our perspective on those portions of the Treasury's November proposal directly affecting the savings institutions business.

Thank you for your attention.

Chairman LaFalce. Thank you very much, Mr. Pitt.

[Mr. Pitt's prepared statement, on behalf of the U.S. League of Savings Institutions, follows:]

STATEMENT OF THEO PITT

On Behalf of the U.S. League of Savings Institutions

Before the House Subcommittee on Economic Stabilization

May 9, 1985

CHAIRMAN LaFALCE AND MEMBERS OF THE SUBCOMMITTEE:

My name is Theo H. Pitt, Jr. I am President of Home Savings and Loan Association of Rocky Mount, North Carolina and appear today on behalf of the U.S. League of Savings Institutions where I serve as Vice Chairman of the Committee on Economic Affairs and as a member of the Legislative Committee.

While the U.S. League is interested in many of the issues in pending tax proposals affecting savers, home owners, and the real estate sector of our economy, my statement this morning will concentrate on those directly affecting savings institutions as corporate taxpayers, in conformity with your gracious invitation to appear before this distinguished Subcommittee.

The U.S. League of Savings Institutions appreciates the opportunity to present its testimony on the proposals contained in the November Treasury report to the President on Tax Reform for Fairness, Simplicity, and Economic Growth. The reform proposals contained in the Treasury report dramatically alter the tax code treatment of major segments of the U.S. economy. The financial sector is one that would be substantially restructured by proposals in this reform plan. In particular the repeal of section 593 proposed by Treasury I would eliminate the specialized tax treatment accorded the Thrift Industry by Congress for the last 23 years. It's the one tax benefit that the industry still has remaining which assists them in their profitable years.

Throughout their existence, thrift institutions have occupied a unique status within the Federal tax structure. Originally designed as mutual companies with little profit orientation, thrifts were exempt from tax until 1951 -- when they were taxed as commercial banks, except that there was no tax liability until reserves for absorbing losses reached 12 percent of savings balances. In spite of the generous deduction of 60 percent of taxable income for "bad debt reserves" allowed by the 1962 Revenue Act, thrifts became taxable for the first time. Congress provided thrifts this favorable reserve treatment in order to assure the availability of home mortgage credit and in recognition of the substantial risks involved in making long-term mortgage loans. However, the tax benefits of Section 593 were not provided without some assurance that savings institutions would remain specialized home lenders. In order to accomplish that the maximum Section 593 benefits were denied unless 90 percent (pre-1969) of a thrift's assets were qualified (i.e., housing related). Today (post-1969) 82 percent of savings and loan and stock savings bank investments must be in cash, government and municipal obligations, real property loans or other housing-related investments for maximum utilization of the bad debt reserves; 72% for mutual savings banks. This investment specialization is the "price" thrifts must pay to enjoy the tax benefits of Section 593.

However, even with the seemingly favorable treatment of Section 593, most thrifts began paying increasing Federal income taxes following the passage of the Revenue Act of 1962. The 1969 Act reduced by one-third the overall value of Section 593's percentage of taxable income benefit. The following table depicts the ten-year 593 percentage reduction required by the 1969 Act as well as recent increases in the tax liability for thrifts caused by the inclusion of the thrift bad debt deduction in the tax preference scalebacks adopted in the 1982 and 1984 Tax Acts.

Taxable Year Beginning	BDD-Percentage of Taxable Income Method	Effective Tax Rate
1969	60%	19.2%
1970	57%	24.28%
1971	54%	25.27%
1972	51%	26.27%
1973	49%	26.93%
1974	47%	27.60%
1975	45%	28.26%
1976	43%	28.92%
1977	42%	29.26%
1978	41%	30.22%
1979	40%	29.46%
1980	40%	29.46%
1981	40%	29.46%
1982	40%	29.46%
1983	34%	30.36%
1984	34%	30.36%
1985	32%	31.3%

Broad Outline of the November Treasury Proposal

The fundamental change wrought by the November plan of the Treasury in the tax treatment of savings institutions would be the elimination of Section 593 of the Internal Revenue Code, placing our institutions under the code provisions applicable to corporations generally. The U.S. League has approached this basic tax law revision with an open mind. The Treasury I proposal would set the basic corporate rate at 33%. Savings institutions enjoy few of the tax Code benefits (except 593) which are available to other depositories or corporations in mining and manufacturing -- such as Accelerated Cost Recovery provisions, the investment tax credit, or the foreign tax credit. Savings institutions do not derive significant income from municipal bonds and other tax-exempt holdings. Therefore, as suggested by the preceding table, our current effective corporate tax rate approximates 31.3% -- very close to the 33% general corporate rate proposed under the Treasury's Tax Simplification and Reform document. Thus, if our special tax treatment is eliminated and a 33% rate applies, our contribution to the nation's corporate tax revenues would remain basically the same as it is today. However, other details of the Treasury plan discourage thrifts from embracing it. These reasons are more fully elaborated on below..

The thrift industry is proud of the important role it has played in making homeownership a more achievable goal for most Americans. Today, more than 54 million homes -- nearly two-thirds of all residential units in the United States -- are owner-occupied. Savings institutions, as the primary source of U.S. residential mortgage credit, have played an important role in financing home-ownership for America. This commitment to housing finance, encouraged over the years by the incentives of Section

593, remains strong today. In fact, mortgage lending by savings institutions reached all-time record levels in 1984. The combined total of loans closed and purchased in 1984 by savings associations and savings banks reached nearly $200 billion. Today, even though some portions of the thrift industry are still operating at a loss, primarily because of portfolios of low-yielding loans made years ago, their strong commitment to mortgage financing continues.

Over the years our tax code has been used effectively to provide individual benefits and encourage economic activity, including home finance. Congress should therefore proceed with care before dismantling a system that has worked so well. But on the other hand, as taxpayers, we acknowledge a need for appropriately structured simplification and reform. The Treasury Tax Reform plan for Fairness, Simplicity and Economic Growth is the initial blueprint for analysis and debate. As we speak this morning the original Treasury blueprint for tax reform is being hastily revised . Consequently, the U.S. League's will confine its comments to specific provisions in the outdated Treasury I package while we await submission of the Administration's revised tax reform proposal to the Congress in the next few days.

Repeal of Section 593

This would eliminate the specific tax code incentive for encouraging housing finance. The argument is that private mortgage investment will be able to replace the amount of housing credit currently provided with the assistance of tax code incentives and that fact remains to be seen. Treasury also argues that repeal of Section 593 will eliminate a disincentive to thrift diversification of investment. However, even with repeal of Section 593, substantial non-tax limitations under Federal law remain on the diversification of a thrift institutions' asset portfolio.

If Section 593 is repealed, it should be totally eliminated along with associated provisions found elsewhere in the code where thrift institutions have been denied tax incentives available to corporations generally. For example, if Section 593 is repealed, the following should also be discarded:

a. a special 50% limitation on the use of the investment tax credit which applies just to thrift institutions; also, thrifts should receive full use of work incentive credit (if retained);

b. a full 85% dividends received deduction should be granted thrifts like other corporations

c. full corporate deductibility of charitable contributions should also be provided if this provision is retained.

Finally, repeal of Section 593 exposes the fragile thrift industry to the uncertainty of full corporate taxation. If corporate tax rates are subsequently increased from the 33% level in the Treasury proposal, savings institutions will be completely exposed to higher tax liability, further delaying our recovery.

Recapture of Past Section 593 Benefits

The Treasury proposes to recapture the tax benefits of accumulated bad debt reserves claimed by thrifts in an amount equivalent to what institutions would have received had they used the commercial bank bad debt method. Our preliminary estimates indicate that the commercial bank method will require a phase-in of approximately $6 billion into thrift income over a ten-year period. If the corporate rate is indeed lowered to 33 percent, this would increase thrift tax liability by an additional $2 billion over and above this normal tax liabilities. Subsequent clarification of the intent of Treasury has revealed that the impact may be "only" an inclusion of approximately $5 billion over ten years with an associated tax bill of $1.67 billion. Though this is certainly an improvement, it still is an unsatisfactory result.

Any recapture would have a severe and immediate impact on the financial statements of savings institutions. For accounting purposes, the entire thrift method bad debt tax savings have been classified as a permanent difference between book and tax income. Commercial banks have treated their tax savings as only a timing difference and have set up a deferred tax liability for their bad debt tax shelter. The only impact on their financial position would be the actual payment of the tax. Savings institutions, by contrast, would probably have to make an immediate transfer of $2 billion or $1.67 billion from their net worth to a deferred tax account. This would eliminate 40% of the anticipated earnings for the thrift industry in the coming year (if interest rates remain at current levels) -- income that is desperately needed to restore capital levels and minimize problems for the Federal Savings and Loan Insurance Corporation.

But, even though our institutions would suffer from recapture to a greater degree than other depositories, it is also unfair to recapture reserves created from assets priced in reliance on earlier tax rules. Any proposal which penalizes institutions who successfully followed Congressional direction and provided housing finance for America is totally unfair, particularly if recapture is not required where other tax incentives are repealed, e.g., the investment tax credit. Therefore, the U.S. League believes the Treasury recapture proposal is unfair and unacceptable.

Net Operating Loss Carryover

Prior to the 1981 tax act, financial institutions had a larger combined net operating loss (NOL) carryover period, back and forward, than regular corporations. The 1981 act extended the regular corporate carryforward period to 15 years giving corporations generally a combined 18 year period -- the 3-year regular corporate carryback was left unchanged. Financial institutions were kept at a combined 15-year period, 10 back and 5 forward, leaving them in a disadvantageous position at a time when generous NOL rules were most needed. Moving to the regular corporate rules would provide a significant increase in our carryforward period while at the same time moving us closer to the general application of regular corporate rules to financial institutions. Any extension of the NOL carryforward rules, however, should also be made available for existing NOLs as was done for regular corporations when their NOL treatment was changed in 1981.

In order to ease the adjustment for institutions to the reduced carryback and increased carryforward treatment, the U.S. League suggests the following phase-in for the new financial institution NOL rules:

Year 1	10 years back,	6 forward	transition to full 18-year combined carryover
2	9 years back,	8 forward	
3	8 years back,	10 forward	
4	7 years back,	11 forward	
5	6 years back,	12 forward	continued transition to regular corporate carryforward
6	5 years back,	13 forward	
7	4 years back,	14 forward	
8	3 years back,	15 forward	

Preserve Emergency Acquisition and Assistance Provisions

We also would like to state our strong concern about the proposed repeal of certain tax-free reorganization provisions, and the tax-free treatment of assistance provided by the FSLIC which was placed in the law by the 1981 Economic Recovery and Tax Act. These tax law changes were provided to assist the FSLIC in attracting merger partners for supervisory merger cases -- thus assuring depositors that their funds were secure and minimizing payouts from the federal insurance-of-accounts fund -- and to aid struggling companies in their efforts to return to profitability.

Thrift institutions still have a significant spread between the interest earned on protfolios of long-term fixed-rate mortgages and current market yields. Thrift institutions are particularly subject to capital market shifts, and are still only part-way through the restructuring of their balance sheets to enable them to compete in the uncertainty and volatility of the deregulated financial environment. The 97th Congress amended Sections 368 and 597 of the Code making it easier for troubled thrifts to be merged or acquired by a healthy institution. Accordingly, it is vital that Congress preserve these important tax changes so that they may continue to provide their limited but necessary benefits.

Conclusion

The U.S. League understands that Treasury's November reform proposal is for discussion purposes only and we are anxiously awaiting the release of the Administration's revised plan sometime next week. However, we cannot let this opportunity pass without questioning any reform proposal which fails to retain a 33 percent or lower corporate tax rate. From our point of view, that is a necessary provision of any reform package we could support. Additionally, as was stated earlier in this statement, recapture of accumulated Section 593 thrift institution tax reserves into income is not only unfair, but totally unaceptable.

The League, however, does support those Treasury I provisions which permit savings institutions to utilize general corporate net operating loss carryback/carryforward rules if it includes existing losses and a reasonable transition period.

The U.S. League appreciates this opportunity to appear before this subcommittee and share its views on these pending issues of tax reform.

Chairman LAFALCE. I thank each of the panelists for their excellent presentation. Anyone who has been reading or listening to your testimony realizes that this is some of the most technical testimony that not only our subcommittee has heard, but I suspect any subcommittee has heard. The arcane features of the Tax Code with respect to the banking industry, much as yesterday's testimony with respect to the insurance industry, are little understood by the public at large. I don't get too many questions on this at my town meetings.

With that we will venture into a few questions, and I would appreciate it, for this gentleman at least, if you would try to understand that I am not fully appreciative of every comment that every one of you made, and I would ask you to elucidate to the best of your ability.

Clearly, I think it is fair to say we do have an industrial policy for the banking sector of our society, and, in part, it is encrusted within our Tax Code.

Is that a fair statement, Mr. Pitt?

Mr. PITT. I think that is a very accurate statement.

Chairman LAFALCE. Mr. Tuccillo and Mr. Martin?

Mr. TUCCILLO. I agree.

Mr. MARTIN. Yes, sir.

Chairman LAFALCE. The question is: Is the Treasury proposal going to make that industrial policy for the banking industry better or worse? I think I am getting mixed signals from you with respect to that; is that correct?

Mr. PITT. I think that is true.

Chairman LAFALCE. Let's go into some specifics. First, although you didn't discuss this in any detail in your oral testimony, it is my understanding that your ardor for the Treasury tax plan, aside from the specific provisions that you have mentioned, could in large part be based upon the impact that indexing of interest rates for inflation would have. If the indexing of interest rates for inflation is dropped in the revised version of the Treasury plan, you might have different thoughts about the tax reform proposal.

Who would care to comment on the centrality of that provision and its impact on your overall evaluation of the Treasury proposal?

Mr. MARTIN. Let me just say that interest indexing is certainly an important element of tax reform, but we see it more as an element of total inflation adjustment of the tax system. If you are going to take out of the tax system the inflation element, it should be done uniformly consistently throughout the code. To do it in only some spots and not in others would be inappropriate. If it wasn't there, however, I am not certain at this time that we would necessarily be against tax reform. However, we do think that if inflation adjustments are there in any respect for any part of the Tax Code, it should be uniformly applied.

Chairman LAFALCE. Mr. Martin, the President, at least until his visit to Spain, was talking about this reform proposal primarily in terms of tax simplification. I always thought that was a misnomer. Of course, in Spain he said what we really need in the United States is a less progressive income tax and that is what we are going to get—which pointed out what I have always felt—that a flat tax is just another way of defining a regressive or, at least, considerably less progressive tax.

Let's look to the term "simplification." Do you think that we are going to have greater simplification with indexing for inflation within the code, specifically indexing of interest?

Mr. MARTIN. Anytime that you get into tax reform I think there are two elements, simplicity and fairness, and they don't always match up. If you strive entirely for simplicity, it could be at the disadvantage of fairness. I think in this instance it may not be simple, but indexing of inflation could be more equitable.

Chairman LAFALCE. I agree with you. I am much more concerned with tax equity than with the concept of simplification, because two-thirds of the American taxpayers use the short form, and for the one-third that use the long form the tax simplification proposal isn't going to make it very much simpler; in fact, it might make it even more complex. That is my judgment. So, I am more interested in the tax reform proposal from the perspective of equity than anything else.

But let's focus in on simplification with respect to indexing of interest. How would that work for an ordinary taxpayer? How would the banks report to the taxpayer, and how would he then fill out his forms and accommodate indexing of inflation both with respect to interest earned and interest that he is allowed to deduct?

Mr. MARTIN. There are a number of ways that it could happen. One way would be to identify all of the assets and liabilities on both sides and apply an inflation adjustment, and an index adjustment to each one of those elements, and that would obviously depend on the inflation present at a particular point in time. It, certainly, would not be necessarily an easy task, but it would be one that could be accomplished.

Chairman LAFALCE. Would the banks then have the responsibility of advising their customers that you earned *x* dollar amounts and a certain percentage rate in interest and the inflation for the year was such and such, therefore, you must pay taxes only on 2 percent of what you earned, or whatever?

Mr. MARTIN. You would have to reprogram your computers to have all the information necessary to do this correctly, but it could be done.

Chairman LAFALCE. I understand how it would be done with respect to interest that is earned. How would it be done with respect to the interest that you want to deduct? How would you do it there?

Mr. MARTIN. Similarly. The deposits would have to be identified in a similar fashion by particular depositors at rates when they came in and identified through any particular year as to the inflation adjustment that would be necessary at that point in time. It would be a similar adjustment.

Chairman LAFALCE. Is there any difficulty utilizing the computers of the financial institutions in performing this service for the consumers? Because clearly the consumer would not have the capacity to do it; the consumer would be totally at your mercy.

Mr. TUCCILLO. Mr. Chairman, financial institutions currently provide for the consumer a 1099 or similar form reporting interest earnings. That form is generated by computer in most cases. Presumably that form would simply reflect under indexing the amount of reportable income, or in the case of a consumer who, say, has a mortgage loan with a financial institution, the amount of deductible interest paid during the course of the year based on some set of factors presumably supplied by the Treasury to the industry. If an institution is already programmed and producing these kinds of reports, then it is in all probability a fairly straightforward programming change to allow this to go through.

The problem occurs not necessarily from the financial institution side but from the Treasury side where closer verification of interest paid and interest earned reporting forms must be done to ensure that tax returns are accurate. That is where the inflation indexing may cause a problem technically and mechanically. It appears to be something that is quite straightforward given the current practices and operations and procedures of the vast majority of financial institutions in the country.

Chairman LAFALCE. Mr. Pitt.

Mr. PITT. Mr. Chairman, it would appear to me that indexing would be a very confusing issue to the general public. It would appear also, from my personal point of view, that the savings institutions business does not have at this point, because of what we have been through and the fragility of our system, the technical expertise that maybe the banking industry has or some of the larger institutions. The vast majority of our institutions are small community oriented institutions. I believe it would be a tremendous burden for them to go through the technical application and the ability to be able to explain to their customers the impact and have them fully understand what indexing is.

On a much broader basis, I think I tend to agree with Mr. Tuccillo. I think it presents a real problem at the Treasury in the effective monitoring, and that is probably a far bigger issue.

Chairman LAFALCE. I would imagine the smaller the institution, the greater difficulty that is going to be imposed. Credit unions, for example, might have an especially difficult time with this. Regrettably, we didn't include them. That was our fault. They are going to submit written testimony.

I have a number of other questions, but I will defer to the other gentlemen of this subcommittee.

I think Mr. Grotberg was first in.

Mr. Grotberg, do you have any questions you would like to ask?

Mr. GROTBERG. Thank you, Mr. Chairman.

My concern goes to the internal affairs of switching from a cash basis to an accrual basis as part of the Treasury function. This is a major accounting change. Would any one of you care to tell me how it would work if you fail to kill it?

Mr. PITT. Mr. Grotberg, I think I can speak for the U.S. League in saying that we would oppose the change to accrual accounting.

Mr. GROTBERG. I am aware of that.

Mr. PITT. Basically it would be for two reasons. One, it would raise our effective tax rate, and two, it would eliminate what I think would be effective tax management currently available under the cash system.

Mr. GROTBERG. The big question among Congressmen and the confused public seems to be that the U.S. Government should switch from cash to accrual, and they grant that it is impossible. But yet we are suggesting that maybe an industry that counts most of the money in America that doesn't come through the Federal Treasury—and you count a lot of that, too—should do the opposite. Not being a banker, I don't know the final impact.

Where would it cost you money? Is it just the fact of change, the massive change being an organizational expense and problem, or would you be paying more taxes?

Mr. PITT. It would be basically in the reallocation of income that has previously been accounted for under the current Tax Code and method of accounting that is setup and the recognition and timing of that income in addition to the ability to effectively manage the timing and recognition of that income. I don't think it would necessarily be in the mechanics of the computations as much as it would be in the planning methods and the recognition and timing.

Mr. GROTBERG. It would be a landslide movement for the CPA industry, I presume.

Mr. PITT. I think that is a very succinct statement.

Mr. GROTBERG. One more question, if I may, Mr. Chairman, regarding the interest-free question of your reserves to the Federal Reserve System. You put up x number of dollars and percentages of your deposits as your reserve. The Federal Government uses the money and you get nothing for it except a guarantee to stay in business. Is that essentially what we are talking about?

Mr. MARTIN. Yes, sir.

Mr. PITT. Yes.

Mr. GROTBERG. What is the basic change that you all agree is necessary?

Mr. MARTIN. I am not certain that we are talking about a change necessarily in the Tax Code, but we do want to have recognition.

Mr. GROTBERG. Is that a political statement in your testimony, that you are already contributing to the cause?

Mr. MARTIN. Yes, that is correct.

Mr. GROTBERG. And you don't anticipate any basic change in that except you want credit for what you are doing now?

Mr. MARTIN. That's correct.

Mr. GROTBERG. You've got it.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you, Mr. Grotberg.

Mr. Carper.

Mr. CARPER. I have no questions. Thank you.

Chairman LAFALCE. Mr. Roemer.

Mr. ROEMER. Thank you, Mr. Chairman. I apologize both to you and the witnesses for being late. It is one of those kind of years this week.

I cannot ask you on the subject on which you testified, but there is a subject related that has been on my mind for some time, and I wonder if you might comment individually.

What is the effective tax rate paid by your industry? We have seen all kinds of studies looking at tax reform, et cetera, et cetera. It always seems that the banking industry on any listing of effective tax rate comes at or near the bottom. What is the effective tax rate and is that a proper perspective that I am getting?

Chairman LaFalce. May I interject for a moment? According to the study of the Joint Committee on Taxation of effective tax rates of selected large U.S. corporations, page 22 of that study, table 2, "Comparison of U.S. Effective Tax by Industry, 1980 Through 1983," the effective tax rate for the financial institutions industry on average during that 1980 to 1983 period was 3.8 percent, which can be compared to some other industries, such as the computers and office equipment at 25.8.

Mr. Roemer. Take the oil industry, John. They are always kicked around. What are they? One percent? Two percent?

Chairman LaFalce. The petroleum industry, 23.5 percent.

Mr. Roemer. Amazing.

Mr. Pitt. I will refer you to page 4 of my written testimony where we have got outlined, beginning in taxable year 1969 and coming through 1985, as to what the effective tax rate for our industry is, and as I stated in my oral testimony, our current effective tax rate is 31⅓ percent.

Mr. Roemer. Thirty-one and a third percent?

Mr. Pitt. That's correct.

Mr. Roemer. Mr. Chairman, would you read that number again? Are we talking apples and oranges?

Chairman LaFalce. I don't know what we are talking about. Do you care to reconcile, Mr. Pitt, your figure with the 1980 to 1983 figure? Or is there some distinction? The 1980 to 1983 average for all financial institutions, according to the Joint Committee on Taxation, was 3.8 percent.

Mr. Pitt. When you say all financial institutions I think you are lumping both savings and loan institutions, savings banks and commercial banks all into one group, and we would respectfully submit that you have to separate those, because as I stated in my oral testimony, we don't have available to us the favorable tax treatment in areas that commercial banks do.

Chairman LaFalce. If yours is 30-some percent, as you state——

Mr. Roemer. Thirty-one point three.

Chairman LaFalce [continuing]. Does that mean we have a negative tax rate for you, Mr. Tuccillo, or for you, Mr. Martin?

Mr. Martin. I do not believe so, but I would be happy to answer that question.

Mr. Roemer. Please do.

Mr. Martin. Let me just say in general what you see there is the tax that is paid as a direct tax to the IRS. However, I think the real question is what is the cost that we are bearing for the advancement of Government. We would suggest that we do certain things through the Tax Code that help support other costs of Government. Most notably, we carry out public policy with regard to financing State and local governments. In financing State and local governments we take significantly lower rates of interest. Those rates of interest are effectively taken because we pay no tax on it. In effect, we are a conduit. We are taking a lower rate and by not paying a tax passing that benefit along, if you will, to the State and local government.

Mr. Roemer. Which part of the financial industry do you represent, Mr. Martin?

Mr. Martin. Commercial banks.

Mr. ROEMER. And you are telling me, and I think legitimately, that there are things beyond the numbers that have to add into the contribution in the broad sense. One is a reservoir of financing for local and State securities taxfree.

Mr. MARTIN. Exactly.

Mr. ROEMER. You end up not paying taxes but you take a smaller yield.

Mr. MARTIN. That is correct.

Mr. ROEMER. So there is a public good done.

One of you gave an example earlier about the Federal Reserve balances required. Are there any other hidden agenda examples?

Mr. MARTIN. There are others, but I think those two are the ones that you should really concentrate on.

Mr. ROEMER. What is the effective rate on your industry?

Mr. MARTIN. After you have included the two elements we have just talked about, studies done by the Bank Administration Institute with regard to the years 1982 and 1983, show an effective tax rate of 52 percent in 1982 and 43 percent in 1983, a significantly higher tax rate.

Mr. ROEMER. Give me two figures, if you would. My time is about to expire, so work with me quickly, if you can. What is the effective rate without any hidden agendas?

Mr. MARTIN. Without any hidden agendas?

Mr. ROEMER. Just the numbers.

Mr. MARTIN. I would not disagree with the number.

Mr. ROEMER. The 3.8 percent you think fairly represents commercial banks in America?

Mr. MARTIN. As I recall, as far as tax payments, per se, I believe that those numbers are not all that inaccurate for large banks. It must be remembered that those numbers are taken from the published financial statements of the 20 largest commercial banks.

Mr. ROEMER. He might be getting some more inaccurate numbers there.

Mr. MARTIN. Chuck Wheeler, ABA tax counsel, has also pointed out that there is obviously a wide variety of tax rates in the industry. Smaller institutions may be paying a significantly higher amount than that.

Mr. ROEMER. I appreciate your answer.

Mr. TUCCILLO. Mr. Chairman, if I may make a couple of comments on the question, I am not sure how the Joint Tax Committee calculated that. There are a wide number of ways of calculating something which could be called an effective tax rate. I would be wary of looking at any one number. If you look at a variety of numbers and they all look about the same, then you would have a little more confidence.

Chairman LAFALCE. We have many different definitions for the word "freeze"; we have many different definitions for the word "cut"; we have many different definitions for the word "increase"; we have many different definitions for the words "effective tax rates." We understand that.

Mr. TUCCILLO. The second thing is that "all financial institutions" range from commercial banks through savings and loan associations, savings banks, credit unions, brokerage houses, et cetera. So the institutions which go into that particular number will also affect it.

Also, if we are talking about the period 1980 to 1983 and we are looking at actual taxes paid, a significant portion of the savings industry were money losers in those years and could have effectively zero tax rates because they had zero income.

But even beyond this, Mr. Pitt's numbers for the savings industry—and those only refer to savings and loan associations and savings banks—are fairly accurate numbers. Those numbers have been calculated a number of different ways over a number of different years. In the savings industry those insitutions which did report positive net income were paying tax rates in the area of 25 to 35 percent. But over and above this there are certain States—and, Chairman LaFalce, your own State is one of them—where savings institutions are subject to taxes which are not related to income. So there are many instances of institutions which have lost money and still paid positive and in some cases significant amounts of taxes. So you might also want to consider that.

Mr. ROEMER. My time has expired, Mr. Chairman.

I would like to ask them to give me some information, if I could. You especially, Mr. Martin, but I open it to any of you. Go back a decade for me, if you could, good times and bad in that decade, and give me two sets of numbers if you would. It would help my studying. One would be effective tax rate paid with no hidden or subjective additions. Two would be for the same years give me your version of effective rate paid, including tax-free services.

Thank you.

Chairman LAFALCE. That is an excellent question. That information would be extremely illuminating.

Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

I would like to address this question to those of you who are representing the thrift industry. It is not in the best financial shape that it has been in past years. That along with the declining balance of the FSLIC. Will the Treasury's plan further endanger the industry? If so, give me a little elucidation on that.

Mr. PITT. Mr. McCandless, as I stated in my oral testimony, I think the basic effective tax rate on the Treasury I proposal is very comparable to our current tax rate. However, the recapture provision of the bad debt reserve does adversely affect our industry. We would be required to recognize for income purpose and would have to make an immediate transfer of, as I stated in my testimony, approximately $1.7 billion for the industry from reserves that have been built up, which is a reduction of net worth, and transfer it to a deferred tax account for future payments. So, yes, it would have an adverse impact and would further erode the already low net worth of our industry.

Mr. TUCCILLO. I would agree with Mr. Pitt on that. The Treasury I proposal has potential for being positive with respect to thrift institutions if certain changes are made in it. The biggest item in it as far as we are concerned is the trade-off of the current bad debt deduction method for the lower corporate tax rate. At a trade-off of the bad debt deduction for a 33-percent maximum corporate tax rate, it appears that we will wind up in approximately the same tax position if the bad debt recapture provisions or proposals are eliminated from that overall package and if certain other changes are made.

As far as the general thrust of the Treasury proposal goes, and I am again eliminating those items which we feel would hurt the industry, the general thrust of the Treasury proposal we feel would strengthen the thrift industry.

Mr. PITT. There are also two other provisions that I spoke to, the 1981 provisions in the Tax Code, which provided special tax treatment of the tax-free FSLIC assistance, and also the net worth certificate program that was set up by the Banking Committee. Under the proposal both of these would be eliminated, and that would further erode and be adverse to our industry.

Chairman LAFALCE. Is it only under the proposal that there are difficulties?

Mr. MCCANDLESS. Is the chairman going to give me extra time for another question?

Chairman LAFALCE. Yes; I just want to follow that up right now.

Is the Treasury's present application of existing tax law giving difficulty to the implementation of that proposal? I think you suggested in your testimony that it was.

Mr. PITT. It is in the proposal, but they are also giving us trouble on it absent the proposal.

Chairman LAFALCE. How is it that they are giving you difficulty on it now?

Mr. PITT. They are raising questions about the tax treatment and the tax-free reorganization as currently set up.

Chairman LAFALCE. Please expand upon that in written testimony in the follow-up letter, OK?

Mr. PITT. Fine.

Mr. MCCANDLESS. We have very limited time, so I would appreciate it if you could be as brief as possible.

In the testimony today you brought up the fact that bad debt deductions may have an adverse effect of discouraging diversification of thrift asset portfolios. Further, elimination of this deduction would encourage investment choices based upon economic rather than tax choices. As a matter of policy should we be encouraging the industry to forgo its commitment to provide housing finance? Isn't this an acceptable social and economic goal that the Tax Code should promote?

Mr. TUCCILLO. We don't believe that the change as envisioned in Treasury I would promote that end. Our feeling is that housing is best served by a strong thrift industry as opposed to a completely dedicated but inert thrift industry. The industry needs to continue to work its way out of the hole that was dug for it in the 1978 to 1982 period. That is a slow process, a tortuous process; it's a process that requires all the tools that are available.

We feel that the shift away from the bad debt deduction in tradeoff for a lower maximum corporate rate will provide the elbow room which is necessary for thrifts to continue that restructuring. We don't envision this as a mandate for abandoning housing, nor do we anticipate that thrifts will change to any great extent their activities. What it will allow them to do in a moderate and judicious manner is implement those powers which were afforded them in the 1982 legislation and become much stronger and more viable corporations and firms and thereby serve the housing industry better.

Chairman LaFalce. Mr. Pitt, you disagree with him on that, don't you? What is your position?

Mr. Pitt. I do not necessarily disagree with him. Our basic position is that we have carried out a socially mandated directive to house America, which we feel we have done as directed by the Congress. To now all of a sudden redirect that thrust causes a tremendous turning process in our organization for which we are not at the present time geared up to do. Diversification of investment for our institutions has to come over a very, very planned period, and we are not in the position, I don't believe, in general in this industry to handle a sudden and jolting reversal and redirection and redeployment of assets. Still, our primary thrust is in housing.

Mr. McCandless. Thank you, gentlemen. The Speaker calls, McCandless listens.

Chairman LaFalce. The Speaker would be glad to know that, Mr. McCandless.

Suppose the Treasury plan were to be enacted unchanged, unmodified. Suppose we had a vote on it as is, Treasury I, not Treasury II. Would you recommend yes or no?

Mr. Pitt.

Mr. Pitt. At this point I think we would have a mixed bag on that. We would have to consider it

Chairman LaFalce. You'd abstain. OK.

Mr. Tuccillo.

Mr. Tuccillo. Am I speaking as a representative of the thrift industry or as someone interested in the general health of the American economy?

Chairman LaFalce. You can speak both ways if you like.

Mr. Tuccillo. My suspicion is that I would have to vote no for two reasons. One is that from the viewpoint of the thrift industry there are a couple of time bombs in there which would be devastating to the industry, net operating loss treatment and the recapture, just to name two. There are several others.

Chairman LaFalce. That net operating loss, the carryback and carryforward, is something that is especially important to the thrift industry and especially important to those institutions which went in and picked up some troubled thrifts.

Mr. Tuccillo. That is correct.

Chairman LaFalce. I would hope if that is not covered by Treasury II that we could cover that independently. I am prepared to move forward on that if it is not included in Treasury II.

Mr. Tuccillo. That would be an extremely positive move for the industry. There are institutions now, the ones to which you alluded especially, which are fast running out of room in terms of using these. Right now in the 5-year carryforward we are back to 1980, and we are coming into a period of 3 years where there were heavy losses and thrift industry income, while it will be positive over the next 3 years, is not going to be sufficient to offset those losses.

Chairman LaFalce. As I say, I hope that that correction will be made in Treasury II. If it is not made in Treasury II, I am prepared to attempt to move on that independently.

Mr. Tuccillo. We would strongly support that change.

Chairman LaFalce. Mr. Martin.

Mr. Martin. I guess what we would say is simplification and tax reform for the individual is obviously very appropriate. On the corporate side, as I said before, fairness doesn't always mean simplicity, and right now we find some significant difficulties in tax reform.

Chairman LaFalce. Let me ask this. If Treasury I were enacted as is, how many additional dollars would the Federal Treasury make with respect to the changes affecting your industry? Do we know that? Because it is the modification of the changes in the corporate Tax Code that would permit the reduction of the individual tax rates and the increases in the personal exemption, for example, and wind up leaving corporate America paying a slightly larger portion of the overall income tax burden. Would your industry wind up paying, given a lower corporate tax rate, but given the changes in the specific provisions that address your industry, more or less? I assume you would wind up paying a little bit more, wouldn't you?

Mr. Tuccillo. We would probably wind up paying more.

Chairman LaFalce. Have you quantified that?

Mr. Martin. We haven't yet quantified it. However, I would suggest that in some of the areas, as they may be changed, they would have a direct impact, not so much on us, but on our customers.

Mr. Pitt. Our effective rate would go up very little. We are already paying pretty much close to what is proposed. But under the recapture provision we would end up paying more taxes.

Chairman LaFalce. Have you quantified that at all?

Mr. Pitt. We have quantified that portion of it at about $1.7 billion over the proposed 10-year phase-in period.

Chairman LaFalce. Gentlemen, I would like to go on, but unfortunately we do have a vote, and it is going to be difficult for me to make it as it is. I will have to run. I want to thank you very much. You have been excellent panelists. You have contributed to the insights of this subcommittee and this Congressman, in any event, for which I am very grateful. I thank you very much.

The subcommittee is adjourned.

[Whereupon at 11:15 a.m. the subcommittee was adjourned.]

[The following additional material was submitted for inclusion in the record:]

Credit Union National Association, Inc.

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HAROLD T. (TOM) WELSH
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Residence: 815/933-1543

May 14, 1985

Honorable John J. LaFalce, Chairman
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to provide you this letter on behalf of the Credit Union National Association, Inc. (CUNA) for the record of your Subcommittee's hearings on the "Consequences of the Treasury Tax Plan for the Banking Industry." CUNA is an association of credit union leagues in each state, the District of Columbia, and Puerto Rico. Through these leagues, CUNA represents approximately 18,500 federally and state chartered credit unions which serve more than 50 million individual members.

The significance of the Treasury proposal for credit unions is unlike that for any other segment of the financial community. For credit unions, this is not a series of revisions in existing tax provisions--some positive and some negative. For credit unions, the Treasury proposal constitutes a complete reversal of established public policy toward the credit union movement. I hope this letter convinces you and the members of your Subcommittee of the tremendous social costs associated with such a policy reversal. It is CUNA's position that: the credit union movement is the healthiest financial system presently in existence; that Federal policy contributes significantly to this condition; that many socially desirable benefits stem from this policy; that policy reversal will undo the fundamental nature of this system; and that the price paid by undoing the system will dwarf the very limited revenue projections of taxing credit unions. Let me explain.

The Treasury proposal, and certain other bills already introduced in this Congress, would reverse a 48-year old public policy decision concerning the credit union movement in this country. This decision, to exempt the income of credit unions from taxation, was deliberated and affirmed in 1937. This was three years after enactment of the Federal Credit Union Act in 1934. The original act permitted states to tax credit unions on the same basis as banks. This was generally done on the basis of share capital. Since by law credit unions cannot accept deposits, all shares were vulnerable to taxation. The tax burden became so oppressive, the Congress established the policy of tax exemption in 1937.

The policy was adopted by the Congress to encourage the success of the credit union movement in order to bring financial services to those who were at a disadvantage in obtaining them elsewhere (hourly wage earners, military, elderly, students, etc.) and to develop a credit union system as an alternative to the traditional "for profit" banking system. In 1951, this policy was reviewed by the Congress and reaffirmed. Because of this policy, there now exists a reliable and rapidly growing source of low cost consumer credit (presently over $100 billion). This system is dedicated by law to the extension of consumer credit.

The tax exempt policy was based on the fact that credit unions are organized and operated on a non-profit basis. They have no capital stock, they are mutually controlled, they are directed by volunteers, and most have close relationships with sponsoring companies. These conditions remain true today. Therefore, Mr. Chairman, I believe the decision before the Congress is not whether credit unions still qualify for the exemption (which they do), but whether the exemption is still warranted. This, of course, is a matter for the Congress to decide but I personally feel the answer is an obvious yes.

Because of the continuous support and encouragement of the Congress, the credit union movement has succeeded in reaching the lives of millions of Americans. This cooperative form of financial services delivery is not profit-driven but rather is fueled by the goal of being of service to members. A necessary ingredient in its success is the continued awareness by government decision-makers of the unique difference between "profit-driven" and "member-driven." Taxation, in addition to its onerous financial and paperwork burdens, would send a clear signal that the Federal government no longer sees nor encourages this alternative for American consumers. It is ironic that this could occur at a time when the Congress is considering a requirement for banks to provide lifeline and other consumer services.

The following social/economic benefits have been realized by a policy which has encouraged the formation of a credit union system:

- The credit union financial system is in excellent financial condition.* Because of its willingness to manage its own problems, there exist no major potential Federal liabilities due to industry crises. This is not true of other systems.

- Through mutual self-help, there is now in place a separate system to meet the liquidity, regulatory, information, and insurance needs of all credit union members.

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*See 1984 Annual Report of the National Credit Union Administration.

- Close personal service is given to all members regardless of their income or size of accounts. This includes financial counseling and the promotion of good credit and savings habits. Basic lifeline services are always available to members of credit unions.

- There are over 250,000 volunteers serving as directors and committee members in these institutions. 33% of all credit unions have no full-time employees.

- Over 50 million American consumers are receiving financial services from over 18,500 credit unions (50% are under $1 million in assets).

- American consumers receive convenient and low cost services from their credit unions. Lower loan rates are available to members because of lower cost of operating credit unions. This is achieved in a large part by serving only members and because they are non-profit.

- In 1984/85, the credit union system used its resources to fully capitalize their central bank and their Federal insurance fund (NCUA). This action reduced the Federal deficit by $1 billion. If credit union growth is not interrupted by taxation, estimates show that further capitalization will reduce the Federal deficit an additional $1 billion by 1990 and by the year 2000, a total reduction of $9.2 billion.

- The credit union movement has always supported what is best for the American consumer and not its own self interests --
    Support for removal of Reg. Q.
    Support for S&Ls to get consumer loan powers.
    Support for truth-in-lending.

- The credit union system has stressed credit union cooperation. It is not based on credit union competition. Like the other systems, it has been subjected to severe economic shocks. A crisis of confidence has been avoided because of working together.

The following are the anticipated disruptions in the credit union system resulting from a policy reversal on taxation.

- The safety and soundness implications are seriously troublesome. Since credit unions have no capital stock, they must use their undivided earnings as a means of preparing for major changes or unexpected market forces. Tables I-III show the impact on the credit union movement of a 33% tax rate. The results show a cumulative reduction in undivided earnings of 66.4% during the period 1975-1984. During the same period, the cumulative reduction in overall equity (reserves and undivided earnings) is 25.4%. In other words, taxation would reduce the present equity level of the credit union movement from 6.3% ($7.2 billion) of assets to 4.7% ($5.3 billion). This is at a time when the FDIC is recommending an increase in the minimum capital level for banks to 9% and when the S&L industry is desperately seeking new forms of capital. Potential Federal government liability to guarantee the soundness of credit unions is dramatically increased.

Further, taxation has to strike at the heart of the system's willingness to take care of its own problems and, instead, look to the Federal government for protection and continuance of its share of the financial market.

- In order to minimize the impact of taxation, individual credit union managers will be forced to adopt a tax avoidance strategy. All management decisions will be tempered by their tax implications. Almost instantly, credit union management will become "profit-driven."

- Pressure will mount to eliminate free and "unprofitable services." Small loans, financial counseling, low balance share draft (checking) accounts, and no-fee accounts are obvious potential victims of such pressures.

- To seek out the more "profitable" accounts, pressure will soon arise to permit credit unions to serve the general public.

- As part of this trend, we will likely see the loss of the volunteer force within the movement as a direct result of taxation. The loss of volunteers and the volunteer spirit could be one of the most expensive social costs of taxation.

- The overall financial condition of the system will feel the impact of collective decisions to increase yield by increasing risk. This danger is minimal in a "member-driven" system which accounts, in a significant part, for today's relative health in the credit union movement. Unlike banks and S&Ls, credit unions have not been pressured into a situation where risky loans or investments appear to offer the only possible solution.

- The financial and paperwork burdens of Federal taxation will be exacerbated as individual states assert their prerogatives to impose their form of credit union taxation.

- This expanding and reliable "well" of low cost consumer credit will be capped and rendered obsolete.

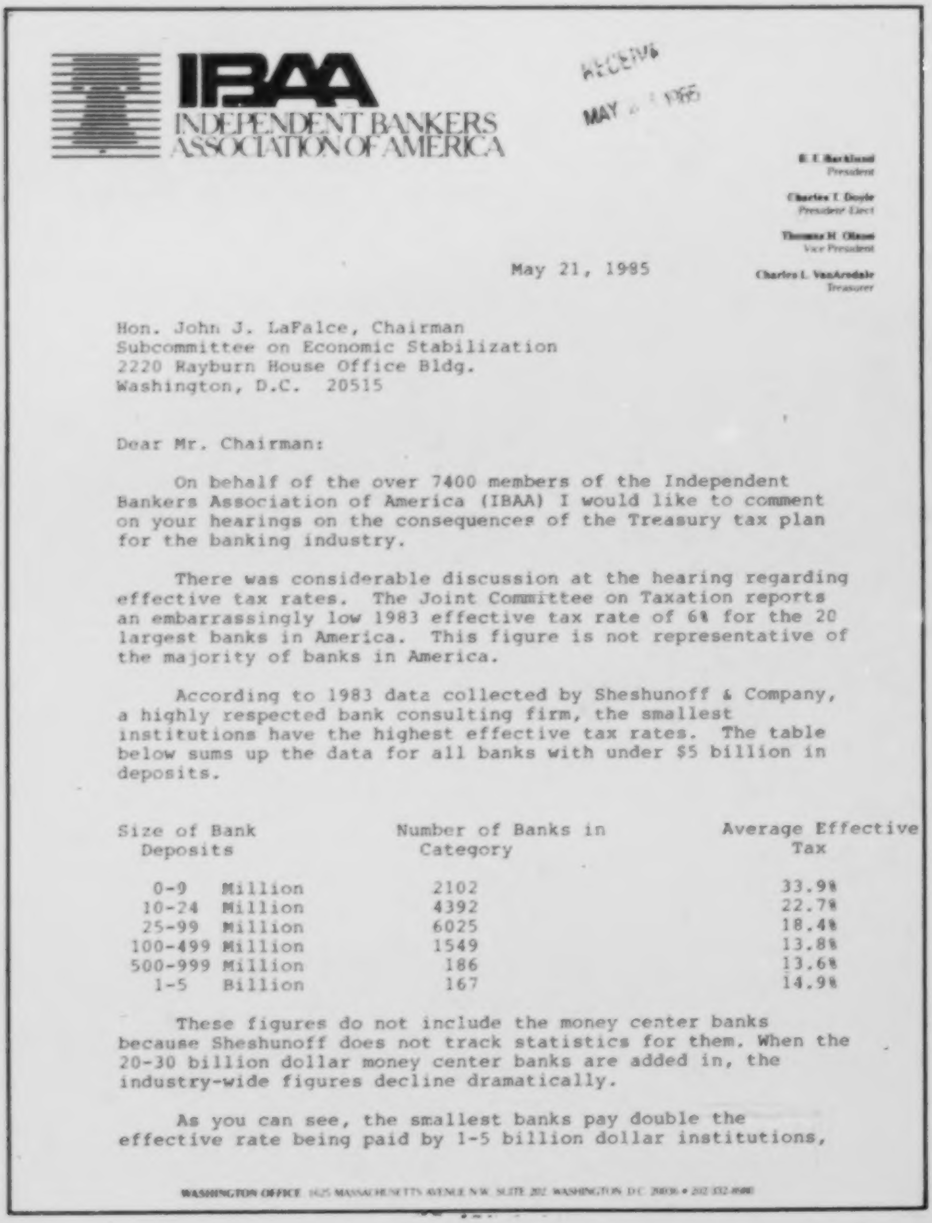
In closing, Mr. Chairman, I would ask the Subcommittee to give its full consideration to what we have set forth in this letter. We are being asked to consider taxation as a means of contributing perhaps $200-$500 million per year to Federal revenues. If that were the only cost of this proposal, I might have responded differently. Having spent the last 29 years in the credit union movement, however, I sincerely believe that the real choices are accurately portrayed in this letter.

I thank you for the opportunity to present the views of our association.

Sincerely,

Harold T. Welsh

Harold T. Welsh
Chairman



IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

E. T. Barklund
President

Charles T. Doyle
President-Elect

Thomas H. Olson
Vice President

Charles L. VanArsdale
Treasurer

RECEIVED
MAY 1985

May 21, 1985

Hon. John J. LaFalce, Chairman
Subcommittee on Economic Stabilization
2220 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of the over 7400 members of the Independent Bankers Association of America (IBAA) I would like to comment on your hearings on the consequences of the Treasury tax plan for the banking industry.

There was considerable discussion at the hearing regarding effective tax rates. The Joint Committee on Taxation reports an embarrassingly low 1983 effective tax rate of 6% for the 20 largest banks in America. This figure is not representative of the majority of banks in America.

According to 1983 data collected by Sheshunoff & Company, a highly respected bank consulting firm, the smallest institutions have the highest effective tax rates. The table below sums up the data for all banks with under $5 billion in deposits.

Size of Bank Deposits	Number of Banks in Category	Average Effective Tax
0-9 Million	2102	33.9%
10-24 Million	4392	22.7%
25-99 Million	6025	18.4%
100-499 Million	1549	13.8%
500-999 Million	186	13.6%
1-5 Billion	167	14.9%

These figures do not include the money center banks because Sheshunoff does not track statistics for them. When the 20-30 billion dollar money center banks are added in, the industry-wide figures decline dramatically.

As you can see, the smallest banks pay double the effective rate being paid by 1-5 billion dollar institutions, and more than quadruple the rate paid by the 20 largest banks. The average IBAA bank has approximately $21 million dollars in deposits.

The IBAA asks whether these figures could be made part of the record of your hearings. Community banks in America are paying their fair share even though other segments of the industry may not be. The 20 largest banks, cited in the joint committee's study, are not subject to the discipline of the market; they are fail proof. Community banks are subject to the disciple of the market and should not be penalized by tax reform proposals aimed at the money center giants.

Thank you for your time and consideration.

Sincerely,

B. F. Backlund

B.F. Backlund
President

cc: All members of Subcommittee

NAFCU
National Association of
Federal Credit Unions
P.O. Box 3769
Washington, DC 20007
703/522-4770

Statement of the National Association of Federal Credit Unions

The Economic Stabilization Subcommittee

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

on

Impact of Tax-Simplification Proposals on the

Financial Services Industry

May 9, 1985

Mr. Chairman and members of the Subcommittee on Economic Stabilization, the National Association of Federal Credit Unions (NAFCU) appreciates the opportunity to make a statement for the record on the impact of current tax-simplification proposals on the financial services industry--in particular, their impact on Federal credit unions. As the only trade association which exclusively represents the interests of credit unions chartered by the federal government, NAFCU has a strong interest in the current issue of tax reform since most of the proposals before the Congress to reform the nation's tax laws would repeal the federal tax exemption for credit unions. That tax exemption, in the case of Federal credit unions, dates to the beginning of the Federal credit union movement in the 1930s. NAFCU urges that the exemption be retained so that over five decades of growth and progress in the Federal credit union movement can go forward, unabated.

Role of Credit Unions

For the benefit of the members of the subcommittee, perhaps it would be helpful to briefly describe the role that Federal credit unions play in the financial-services industry. First, credit unions are profoundly different from banks and savings and loan associations. Unlike those institutions, credit unions are non-profit, cooperative organizations that are totally committed to providing people of moderate means with a strong return on their savings while giving them the opportunity to borrow for consumer, home, and education purposes at the most reasonable rates of interest. Because of their non-profit, cooperative origins, credit unions are imbued with a spirit of democratic control and a strong sense of volunteerism. Under the Federal Credit Union Act (12 U.S.C.§§1751-1795), all members of a Federal credit union, regardless of the size of their shares (accounts), are entitled to an equal vote in the determination of the affairs of the credit union. In addition, the board of directors of a credit union, with the exception of one member, serve by law without compensation.

Moreover, Federal credit unions do not serve the general public. As membership organizations they may serve only a specified membership field--in which the members share a common bond of occupation or association, or reside within a well-defined neighborhood, community, or rural district. In addition to these limitations on membership, credit unions are restricted in the types of services they may provide. For example, credit unions may make loans only to individuals; they may not make loans to businesses nor charge a penalty for prepayment of any loan.

There are approximately 10,500 Federal credit unions in the United States, representing 27.5 million members. Approximately eighty-eight percent of Federal credit unions have assets of less than $10 million. Typically, the average-size credit unions' assets total no more than $3 million to $5 million. At the end of 1983, state and Federal credit unions held less than six percent of the small time and savings deposits in financial organizations.

Evolution of Credit Unions' Tax-Exempt Status

Since the 1860s, the tax laws at the federal level have almost uniformly recognized that cooperatives and other non-profit institutions should be treated differently from profit-making entities. The law makes this distinction by taxing the distributions of non-profits at the membership level--*de facto* recognition that the institutions are merely extensions of their members and that they do not have a separate identification for tax purposes. This distinction has been ever-apparent in the case of credit unions since, as small cooperatives, they have always operated on a non-profit basis, and since they have membership and service restrictions that limit their competitive stance with other financial organizations.

The tax-exempt status of state-chartered credit unions was recognized in a 1917 opinion of the Attorney General of the United States, and was formally conferred in the statutes by the Revenue Act of 1951. As indicated earlier in this statement, the charter act for Federal credit unions, the Federal Credit Union Act of 1934, as amended, grants a full federal tax exemption to Federal credit unions.

Provisions of Current Tax-Simplification Proposals

Three of the major tax-reform proposals now in the Congress would remove the tax exemption historically granted to credit unions. Specifically, S. 409/H.R. 800, introduced by Senator Bill Bradley (D-NJ) and Congressman Dick Gephardt (D-MO); S. 321, by Senator Dennis De Concini (D-AZ); and H.R. 1040, a modified version of the Treasury tax-reform plan introduced by Congressman Charles Rangel (D-NY), would repeal the credit union tax exemption. S. 1006/H.R. 2222, introduced by Senator Bob Kasten (R-WI) and Congressman Jack Kemp (R-NY), would retain the tax exemption for credit unions because the sponsors feel strongly that credit unions are unique financial institutions whose non-profit status justifies their current tax treatment. NAFCU has recently received written reaffirmation of support from Senator Kasten and Congressman Kemp on the tax issue.

Proponents of repeal, on the other hand, base their arguments on the issue of equity: the need to treat financial institutions alike for tax purposes so that one group does not enjoy either an economic or competitive advantage over another. This argument fails to consider that other financial organizations, such as banks and savings and loans, operate in the open marketplace to the benefit of their stockholders. By contrast, credit unions serve only their own field of membership and function for the sole benefit of their members/depositors. There is no separate class of owners in a credit union--the members own all of the assets--and there is, therefore, no profit motive. Members pay federal taxes on their dividends--as is the case with other cooperatives.

Unique Volunteer Aspect of Credit Unions

A central feature of the credit union movement is the substantial volunteer effort at both the board-of-directors level and at the operating level--a feature not found in other financial organizations. This spirit of volunteerism and the strong community orientation of credit unions go hand in hand. By law, board members, except for a single member, must serve on a volunteer basis since they may not be compensated. At the present time, there are over 250,000 volunteers in the credit union movement. In fact, at least one-third of the almost 20,000 credit unions in the nation have no full-time employees. They carry out their financial services with volunteers for the most part.

At first glance, one might say that taxing credit unions would not disrupt this historical community connection in the credit union movement; but as a result of taxation we foresee pressures developing to compensate directors and other volunteers. In that eventuality, an important, albeit intangible, quality in the credit union community would be lost. Moreover, many of the hundreds of small, community credit unions would be devastated financially if they were required to compensate their officers and support personnel. Across the credit union spectrum, these services are estimated to be worth some $200 million in this calendar year.

Safety and Soundness

Another major concern of the credit union movement over taxation is the effect on safety and soundness--two fundamental elements of the credit union philosophy. Unlike stock-issuing financial institutions--such as banks and savings and loans--the ownership of credit unions is reflected in members' holdings of shares (savings) in the credit union. Therefore, there is no source of capital other than retained earnings to provide for contingencies and for expansion. While the effects of taxation on credit unions' equity would differ under each of the bills now before the Congress proposing the taxation of credit unions, most of the studies done within the credit union community estimate the impact on equity to be considerable.

This troublesome possibility prompted the former Chairman of the Board of the National Credit Union Administration (NCUA) to write to the Chairman of the Senate Finance Committee in February of last year during the Committee's deliberations on proposed legislation to reduce the deficit. The NCUA Board Chairman stated in that letter: "In my judgment, the taxation of credit unions could seriously affect their financial soundness." NAFCU feels strongly that these cautionary words should be closely considered anew by the Congress as it fully enters the debate on tax reform.

Other Effects of Taxation

Apart from these possible scenarios following taxation of credit unions, there is a likelihood that boards of directors would pay out as dividends reserves needed for expansion--as a means to avoid taxation at the entity level. This was the tendency on the part of mutual savings institutions in the United

States following removal of their tax exemption in 1951, and of credit unions in Canada when they were taxed. Eventually, credit unions would lose their identity and would, of necessity, become more like banks and savings and loans. Even in this case, only the strongest and fittest credit unions would be able to compete with the other classes of financial institutions.

Credit Unions' Contributions on the Deficit

Returning to the issue of equity for a moment, Mr. Chairman, credit unions believe that there is a substantial economic argument to be made for maintaining the present tax exemption for credit unions. Historically, credit unions have paid maximum dividends to their members, after making provisions for statutory reserves, and all such dividends are, of course, taxable at the membership level. By paying out most of their earnings as taxable dividends, credit unions continue to adhere to traditions of the credit union movement: providing the maximum possible savings return to members after setting aside statutory reserves necessary for safety and soundness of operations, and small, prudent reserves needed for member services.

Recent developments, attendant to the implementation into law of the Deficit Reduction Act of 1984, strengthen the argument that credit unions do their part in contributing to a sound national economy. On January 21, 1985, all credit unions with Federal insurance were required to deposit with the National Credit Unions Share Insurance Fund, in the Treasury, an amount equal to 1 percent of their insured shares. This requirement has as its long-term purpose the building of the reserves of the Fund; but its short-term effect was to reduce the FY 1985 budget deficit by almost $800 million. These funds are a significant part of the additional monies raised to combat the deficit in this fiscal year. In fact, figures from President Reagan's 1986 budget indicate that credit unions contributed 8 percent of the revenue expected to be gathered in FY 1985 by the federal government under the authority of the Deficit Reduction Act of 1984.

Credit Unions did not wait to be led into this action on the deficit; they actively sought enactment of legislation in the Congress. This firm action shows the support of credit unions for sound economic initiatives. But credit unions must also grow with the times in order to serve their members. Taxing credit unions' reserves would reduce the source of growth capital and thus inhibit their ability to attract new deposits. There is no economic logic, in our view, in risking the viability of the credit union movement for, at best, a marginal increase in federal revenues.

Conclusion

In summary, Mr. Chairman, we believe that credit unions' place in the structure of the financial services industry would be adversely affected if the current proposals in the Congress to tax credit unions were enacted. Their special niche as providers of low-cost financial services to individuals of modest means would be in jeopardy; indeed, we envision that many credit unions would not be able to pay a sufficient return on savings to enable them to compete with larger financial institutions, such as banks and savings and loans.

Our view is that credit unions are unique institutions and that they must not be forced into direct competition with much larger organizations that can offer a broader array of services--both because credit unions have statutory restrictions on the services they can offer and because larger organizations have much greater economic resources. Credit unions are special financial institutions for other reasons: they play an important role in the lives of employees at their work sites; they serve senior citizens and other similar groups of individuals within their associations; and, they make important contributions to inner-city residents and to rural inhabitants who may not have other financial-service options available to them.

Mr. Chairman, we firmly believe that credit unions play an important role in both the employment and community lives of our members and that the current tax treatment of credit unions is necessary to maintaining and building on the spirit of community, service, and volunteerism that are so fundamental to the movement.

THE REGIONAL CONSEQUENCES OF TAX SIMPLIFICATION: THE DEDUCTIBILITY OF STATE AND LOCAL TAXES

THURSDAY, MAY 23, 1985

SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10 a.m. in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Representatives LaFalce, Cooper, Carper, Kanjorski, and Wortley.

Chairman LAFALCE. The Subcommittee on Economic Stabilization will come to order.

The subcommittee will recess for approximately 15 minutes and begin hearing its testimony at approximately 10:20 because a vote is now taking place. The subcommittee is in recess.

[Recess.]

Chairman LAFALCE. The subcommittee will come to order and reconvene.

Today's hearing is the sixth in a series of hearings the Subcommittee on Economic Stabilization has been holding on the consequences of the Treasury Department's proposal to simplify our Federal income tax system.

In previous hearings we examined the possible impact of the proposal on the manufacturing sector, the real estate and construction industries, and the insurance and banking industries.

Today we will look into one of the most controversial and fiercely debated aspects of the Treasury's plan—the proposal to end the deductibility of State, and local taxes.

The proposal to eliminate State and local tax deductibility, in my judgment, is nothing less than a frontal attack by the Federal Government on the most essential power of States and localities.

Since the imposition of the first emergency Federal income tax during the Civil War in 1862, and since the creation of our present Federal income tax system in 1913, State and local taxes have been deductible from the Federal income tax. Deductibility is an explicit recognition that income once taxed by State and local governments should not be taxed again by the Federal Government.

To do so, as recommended in the Treasury's initial tax plan, would subvert our federal system of government in a most fundamental way and subject our citizenry—for the very first time—to double taxation on the same income.

Further, the elimination of deductibility could have disastrous economic consequences for States and cities in every region of our country. Elimination of that deduction, particularly at a time of drastic cutbacks in other forms of Federal assistance, would jeopardize the economic stability of many States and localities and limit their ability to provide essential public services.

Governors, mayors, State budget officials, State education officials, and experts on State and municipal finance, have warned of the danger of tax revolts by citizens irate over what they would perceive to be unwarranted increases in State and local taxes if deductibility were ended.

This could lead to drastic cutbacks in essential State and local services and damage the creditworthiness of State and local governments in the bond markets. It could also result in a migration of taxpayers from high tax to low tax States further eroding the tax base of States dependent on deductibility.

Certain individuals might not care about this suggestion that individuals can vote with their feet, but it would seem to me that if we are at all interested in the preservation of the concept of federalism, that we ought not to encourage this type of migration.

And make no mistake, the ultimate burden of the reduction in State and local services resulting from all this would fall on the most vulnerable, the poor, who tend to be heavily concentrated in high tax States.

Let's also make it very clear that this is an issue that affects not only States such as New York and California, but States and localities in every region of our country—from Massachusetts and Maryland in the East, to Virginia and South Carolina in the South, to Michigan and Wisconsin in the Midwest, to Oregon and Hawaii in the West. This is a national issue.

And we are fortunate to have with us today, spokespeople from organizations representing States and localities in every region of our country to make clear that this is an issue that is national in scope.

In addition, we have a representative from the educational community to comment on the consequences elimination of deductibility would have on our public education system.

In my judgment, the most devastating impact might well be on our public education system. In virtually every school district in America, the voters have no ability, given the representative system of democracy that we have, to vote on local budgets, to vote on State budgets. They do, though, have the ability to vote on the educational budgets. And here is where they might take out their wrath. They might vote down education budget after education budget, contributing to the difficulties that our educational system has been having.

If we believe that the problems our educational system has is the moral equivalent of war, it seems to me that we ought to be on the side of the educational system in that war, not have a declaration of war against the educational systems of the United States. The elimination of the deductibility of State and local taxes is a virtual declaration of war against the educational system in the United States.

We had planned to have a representative from Merrill-Lynch on behalf of the Public Securities Association to discuss the impact that elimination of deductibility would have on the credit markets for State and local bonds. Many analysts fear that the public pressures to reduce State and local taxes that might follow from ending deductibility would have a most negative effect on the creditworthiness of States and localities. That could lead to increased amounts of short-term borrowing, a more expensive, less reliable revenue source that would weaken the financial stability of State and local governments. It would also make more expensive the essential investment in infrastructure improvement vital to our economic competitiveness.

Studies are now underway to examine this critical aspect of the deductibility issue in greater depth. This subcommittee, therefore, will turn to this aspect of the issue when the studies are completed in the near future, rather than having presentations prior to completion of the study.

I am pleased to welcome this morning, first, my distinguished colleague from New York, Senator Alfonse D'Amato.

Mayor Daniel Griset of Santa Ana, CA, not speaking only on his own behalf but on behalf of both the National League of Cities and the U.S. Conference of Mayors.

Dr. Louis Stettler, the State Budget Director of Maryland, and also speaking on behalf of the National Association of State Budget Officers. And Linda Tarr-Whelan, the director of governmental relations for the National Educational Association.

Out of traditional principle and in order to accommodate the unbelievable frenzied schedule of U.S. Senators, we are going to have Senator D'Amato first and then we will form a panel with the other members.

Senator D'Amato.

STATEMENT OF HON. ALFONSE M. D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Mr. Chairman, thank you so very much for your graciousness.

Mr. Chairman, let me commend you for convening these hearings to analyze the impact of Treasury's plan, particularly as it relates to the repeal of the Federal tax deductions for State and local property, sales, and income taxes.

Mr. Chairman, at the outset, let me suggest to you that it's rather difficult to be against tax reform for fairness, simplicity, and economic growth. I don't know of anyone in the U.S. Congress or any other place who would be against those wonderful sounding principles. I know that the chairman certainly is not against fairness, simplicity, and economic growth.

Chairman LAFALCE. I'm also for motherhood and apple pie.

Senator D'AMATO. That's the only thing that's been left off here along with the flag.

I'm for fairness, simplicity, and economic growth, but I have some grave reservations with respect to certain aspects of that plan which is being submitted for consideration.

Mr. Chairman, since the Federal income tax was first enacted in 1913, Congress has insured that individuals were protected from the evils of double taxation. This was done through the deduction for State and local taxes. By allowing the deduction, Congress protected individuals from paying Federal taxes on income previously spent on State and local taxes. Put another way, Congress protected the people from paying taxes on taxes, from paying taxes on income that they did not have at their disposal.

Since the current Internal Revenue Code was passed in 1954, corporations have been protected from the evils of double taxation on their foreign income. If a corporation pays taxes overseas, that amount is credited against his U.S. tax liability.

For instance, if General Electric pays $100 million of taxes to France, then $100 million may be taken off their U.S. tax obligation; that's a tax credit.

Now, Treasury wants to radically change the rules for both individuals and corporations. Treasury bureaucrats believe that individuals should be forced to pay taxes on taxes and this would be accomplished by repealing the deduction for State and local taxes.

Interestingly, however, the same Treasury bureaucrats do not believe that corporations should bear the burden of double taxation. Treasury has proposed that companies now be relieved for virtually any form of double taxation.

First, Treasury preserves the entire foreign tax credit with only small modifications. In short, Treasury is saying that a company should get a tax break on its U.S. taxes if it pays any taxes in Japan. For example, if a middle-income person pays taxes to support the local school system in Los Angeles or Bridgeport or Buffalo, then no Federal deduction should be allowed.

Think about it. A company that pays taxes overseas receives a full tax credit, but under Treasury's plan an individual who pays taxes locally does not even get a deduction. I think it's rather disgraceful and shameful; I think it's illogical.

Treasury claims that their purpose is neutrality in the Tax Code but then they propose that people and corporations be treated differently so that you're better off being a corporation that pays taxes to a foreign government and gets a total tax credit. But if you're an individual, living in this country, working in this country, paying taxes to your local school district, your local county, your city, your State, you cannot even deduct those taxes.

Mr. Chairman, I think it cries out, and it's not an issue that is one for New York, but an issue for all peoples.

On top of this, I think Treasury also proposes that companies also not incur double taxation on dividends that they pay. This, they say, would be accomplished by allowing companies to deduct half of their dividends paid to stockholders from their corporation income.

By proposing this change, Treasury clearly has indicated its belief that double taxation of corporate dividends is evil. But if double taxation is evil for companies, why is it not also evil for individuals?

When Treasury admits that double taxation is wrong, they happen to be correct. But it is Treasury's thirst for additional revenues that has resulted in their ignoring this obvious contradiction and proposing repeal of deductions for State and local taxes.

There's an important principle at stake and it's a principle of double taxation, whether or not it's right or wrong.

And this is an issue for all of the Nation, Mr. Chairman, not just your State and my State; not just California; not just those States that have high income or real property taxes. Mr. Chairman, let me, if I might, share another thought with you.

I wonder how many working, middle-class families are aware of the fact that, if this proposal is passed in its present form, they will lose the ability to deduct their local real property taxes.

A major portion of those local real property taxes, as you've indicated, go to the support of local school districts. I wonder how much thought has been given to the fact that the values of everyone's home, once they lose the right to deduct their local real property taxes, will be reduced. The desirability of homeownership will be reduced. What will be the economic fallout, the economic impact, in terms of the home construction industry? How many people will not be employed as a result of homeownership becoming less desirable as a result of these Tax Codes?

And, Mr. Chairman, I think that we should be very, very careful in doing away with the ability of people to deduct those local real property taxes. I am concerned that homeownership will become less viable; that many working, middle-class families will never have the opportunity to own a home if the home construction industry tails off; that we've never had any economic studies with respect to what that impact would be; and that the American people are entitled to know exactly what is entailed. Yes, there are some excellent recommendations that are submitted in this document in terms of simplicity, in terms of reducing some of the marginal rates, in terms of seeing to it that all individuals and corporations pay their fair share. I think it's rather deplorable that major corporations in America escape the payment of any taxes as a result of tax shelters, as a result of foreign tax credits, and I think it's unacceptable to the American people.

And so there is a great deal of work that lies before us that can be accomplished in bringing about the goals of fairness, simplicity, and economic growth.

But I would submit the deduction of State and local taxes is something that must be preserved.

Chairman LaFalce. Thank you very, very much, Senator D'Amato, for, in my judgment, an outstanding statement.

[Senator D'Amato's prepared statement follows:]

STATEMENT OF HON. ALFONSE M. D'AMATO
AND STATEMENT ON STATE AND
LOCAL TAX DEDUCTION BEFORE
SUBCOMMITTEE ON ECONOMIC STABLIZATION
OF HOUSE BANKING, MAY 23, 1985

MR. CHAIRMAN, I COMMEND YOU FOR CONVENING THIS HEARING TO ANALYZE THE IMPACT OF TREASURY'S PLAN TO REPEAL THE FEDERAL TAX DEDUCTION FOR STATE AND LOCAL PROPERTY, SALES, AND INCOME TAXES. THE IMPACT OF THIS WRONG-MINDED PROPOSAL IS NATIONAL IN SCOPE AND INVOLVES AN IMPORTANT PRINCIPLE: IS DOUBLE TAXATION RIGHT OR WRONG?

SINCE THE FEDERAL INCOME TAX WAS FIRST ENACTED IN 1913, CONGRESS HAS ENSURED THAT INDIVIDUALS WERE PROTECTED FROM THE EVILS OF DOUBLE TAXATION. THIS WAS DONE THROUGH THE DEDUCTION FOR STATE AND LOCAL TAXES. BY ALLOWING THIS DEDUCTION, CONGRESS PROTECTED INDIVIDUALS FROM PAYING FEDERAL TAXES ON INCOME PREVIOUSLY SPENT ON STATE AND LOCAL TAXES. PUT ANOTHER WAY, CONGRESS PROTECETD PEOPLE FROM PAYING TAXES ON TAXES.

SINCE THE CURRENT INTERNAL REVENUE CODE WAS PASSED IN 1954, CORPORATIONS HAVE BEEN PROTECTED FROM THE EVILS OF DOUBLE TAXATION ON THEIR FOREIGN INCOME. IF A

CORPORATION PAYS TAXES OVERSEAS, THAT AMOUNT IS A CREDIT AGAINST U.S. TAX LIABLITY. FOR INSTANCE, IF GENERAL ELECTRIC PAYS $100 MILLION OF TAXES TO FRANCE, THEN $100 MILLION MAY BE TAKEN OFF GENERAL ELECTRIC'S U.S. TAX OBLIGATION.

NOW TREASURY WANTS TO RADICALLY CHANGE THE RULES FOR BOTH INDIVIDUALS AND CORPORATIONS. TREASURY BUREAUCRATS BELIEVE THAT INDIVIDUALS SHOULD BE FORCED TO PAY TAXES ON TAXES. THIS WOULD BE ACCOMPLISHED BY REPEALING THE DEDUCTION FOR STATE AND LOCAL TAXES.

INTERESTINGLY, HOWEVER, THESE SAME TREASURY BUREAUCRATS DO NOT BELIEVE THAT CORPORATIONS SHOULD BEAR THE BURDEN OF DOUBLE TAXATION. TREASURY HAS PROPOSED THAT COMPANIES NOW BE RELIEVED FROM VIRTUALLY ANY FORM OF DOUBLE TAXATION.

FIRST, TREASURY PRESERVES THE ENTIRE FOREIGN TAX CREDIT WITH ONLY SMALL MODIFICATIONS. IN SHORT, TREASURY SAYS THAT A COMPANY SHOULD GET A BREAK ON ITS U.S. TAXES IF IT PAYS ANY TAXES IN JAPAN, FOR EXAMPLE. BUT IF A MIDDLE-CLASS PERSON PAYS TAXES TO SUPPORT THE LOCAL SCHOOL SYSTEM IN LOS ANGELES, OR BRIDGEPORT, OR BUFFALO, THEN NO FEDERAL DEDUCTION SHOULD BE ALLOWED.

THINK ABOUT IT, A COMPANY THAT PAYS TAXES OVERSEAS WOULD RECEIVE A FULL U.S. TAX CREDIT, BUT, UNDER TREASURY'S PLAN, AN INDIVIDUAL WOULD NOT EVEN RECEIVE A TAX DEDUCTION.

THIS IS DISGRACEFUL. TREASURY CLAIMS THAT THEIR PURPOSE IS NEUTRALITY IN THE TAX CODE. BUT THEN THEY PROPOSE THAT PEOPLE AND CORPORATIONS BE TREATED DIFFERENTLY.

ON TOP OF THIS, TREASURY ALSO PROPOSES THAT COMPANIES ALSO NOT INCUR DOUBLE TAXATION ON THE DIVIDENDS THEY PAY. THIS WOULD BE ACCOMPLISHED BY ALLOWING COMPANIES TO DEDUCT HALF OF THEIR DIVIDENDS PAID TO STOCKHOLDERS FROM THEIR CORPORATE INCOME.

BY PROPOSING THIS CHANGE, TREASURY CLEARLY HAS INDICATED ITS BELIEF THAT DOUBLE TAXATION OF CORPORATE DIVIDENDS IS EVIL. BUT IF DOUBLE TAXATION IS EVIL FOR COMPANIES, WHY IS IT NOT ALSO EVIL FOR INDIVIDUALS?

WHEN TREASURY ADMITS THAT DOUBLE TAXATION IS WRONG, THEY ARE RIGHT. BUT IT IS TREASURY'S THIRST FOR ADDITIONAL REVENUES THAT HAS RESULTED IN THEM IGNORING

THIS OBVIOUS CONTRADICTION AND PROPOSING REPEAL OF THE DEDUCTION FOR STATE AND LOCAL TAXES.

THERE IS AN IMPORTANT PRINCIPLE AT STAKE IN THIS DEBATE: IS DOUBLE TAXATION RIGHT OR WRONG? THIS IS AN ISSUE FOR ALL THE NATION, NOT JUST ONE OR TWO STATES. THIS IS WHY I WILL VIGOROUSLY FIGHT ANY ATTEMPT TO REPEAL THE DEDUCTION FOR STATE AND LOCAL TAXES.

THANK YOU, MR. CHAIRMAN.

Chairman LAFALCE. I understand your schedule is quite hectic; therefore, I am not going to ask any questions. I wonder if anybody else here has questions of the Senator.

Mr. Carper?

Mr. CARPER. Just one question.

First of all, thank you for your testimony.

I was just wondering, what is the top marginal personal income tax rate in New York State?

Senator D'AMATO. The top rate is 10 percent under a compromise fashioned by a bipartisan effort in the State legislature with the Governor. That rate will come down to 9½ percent this year and I believe 9 percent next year. They have fashioned a package that will result in a 1-percent decrease in State income tax.

Mr. CARPER. Do people who work in New York City also pay an income tax?

Senator D'AMATO. Yes, they do.

Mr. CARPER. Any idea what that is?

Senator D'AMATO. It's either 4 or 5 percent, so that you're talking more about a marginal rate than a 14- to 15-percent rate that has been historic. And I would hope that, notwithstanding any proposals, States would recognize that they have an obligation to reduce those burdens. I have to commend them, the State legislature and the Governor, for moving in that direction.

Mr. CARPER. Are you advocating that we continue to maintain the status quo, vis-a-vis the deductibility of State and local taxes, or do you think—is there some reasonable middle ground?

Senator D'AMATO. Well, I think it is a reasonable middle ground to say that people should not have to, or be forced to, pay taxes on income that they do not keep. I think there is the question of the State's sovereign ability to levy taxes. I believe if we look historically, the Federal Government has recognized in its tax provisions that to move so drastically as suggested by elimination would produce something that is totally unfair and unreasonable. I believe economic dislocation would result.

So there certainly is a vested interest from a position as a representative of the State of New York, which I articulate, but in addition to that, let's move one step further.

I do believe that the ability to deduct one's local real property taxes is important for people who live in Colorado, or in Florida, just as it's important for people who live in New York. And that's a principle that I think that we should not lose sight of.

I find it difficult to reconcile how we can, in one hand, say that if you work as an individual or corporation and pay taxes abroad to foreign government, that we'll give you a tax credit. I don't think many Americans realize what they are saying. They're saying they will offset your total tax liability. But if you pay taxes to a local jurisdiction, whether it be New York or any other State, that you will not even be allowed to deduct them.

Mr. Carper. Should individuals, in your judgment, be allowed to deduct the money they pay for sales taxes?

Senator D'Amato. Certainly.

Mr. Carper. Thank you very much.

Chairman LaFalce. Senator, thank you very, very much.

Senator D'Amato. Thank you very much, Congressman.

Chairman LaFalce. I would like unanimous consent from the subcommittee ~~to leave~~ the record open for the prepared statements of a number of Members of Congress who have requested time to appear before this subcommittee, but for which we do not have time. Senator Moynihan, in particular, has already sent me his statement.

Any objections?

[No response.]

Chairman LaFalce. So ordered.

[The following statements have been received by the subcommittee from Members of Congress:]

Daniel P. Moynihan
New York

United States Senate
Washington, D.C.

May 22, 1985

Dear Mr. Chairman:

You have got just the right idea. The worst, though not the only ill effect of repealing the State and local tax deduction, would be its damage to the very fabric of federalism.

Repeal of the deduction could have the ironic effect of undermining State and local initiative, and centralizing authority in Washington.

I tried to make these points in a speech to the National League of Cities in March. I wonder if you would include it in your hearing record?

Best,

Honorable John J. LaFalce
Chairman
Subcommittee on Economic Stabilization
Committee on Banking, Finance
and Urban Affairs
2220 Rayburn House Office
Building
Washington, DC 20510

FROM THE OFFICE OF

Senator Daniel Patrick Moynihan

New York

FOR IMMEDIATE RELEASE
MARCH 24, 1985

Contact: Lance Morgan
202/224-4451

President Reagan and Chairman Morrill:
A Constitutional Reflection

by

Senator Daniel Patrick Moynihan (D.-N.Y.)

An Address To
The National League of Cities'
Congressional - City Conference
Washington Hilton Hotel
March 24, 1985

Sixteen days into his first term in office, President Reagan addressed the Nation on television and set forth a theory of government which has shaped his administration ever since, and has profoundly changed the direction of American government generally. He said:

> There were always those who told us that taxes couldn't be cut until spending was reduced. Well, you know, we can lecture our children about extravagance until we run out of voice and breath. Or we can cut their extravagance by simply reducing their allowance.

Not everyone would immediately recognize this as a theory of government, but it was surely that and was meant to be. In the tradition of the Framers of the Constitution, and with an assessment of man's weaknesses not different from theirs, President Reagan was addressing the central question of how the powers of government -- for him it was more a matter of activity -- might be limited.

The Framers began by dividing the national government into three branches, with the clear intent that there be an equal division of power between the executive and the legislative branches. This separation of powers reflected the 18th century British arrangement. This model was also followed with respect to the all-important issue of taxes and spending. The Constitution provided, for example, that the power to raise money was that of Congress, and that within the Congress, "All Bills for raising Revenue shall originate in the House of Representatives," which is the body where the people were directly represented, unlike the Senate which then represented the several states. The President was made Commander-in-Chief of the Armed Forces but, again in the British pattern, it was expressly provided that, with respect to the Army, "no appropriation of Money to that Use shall be for a longer Term than two years." This is to say that the Commander-in-Chief was to be kept on 24-month rations. And so we might go through the breadth of that incomparable document, 200 years old two years from now.

Might we take the measure of the President's ingenuity in pursuit of not dissimilar purposes? By the time he became President, Mr. Reagan had come to the judgement that the Federal Government had grown much too large, and would continue to do so unless some radical restraint was placed on the Congress, and for that matter the Executive as well.

He proclaimed his purpose in his third week in office and attained it in his seventh month, with a tax cut that radically reduced the revenues of the Federal government, bringing about a sustained deficit.

The purpose of the deficit was elemental. It was to put in place a permanent process of seeking reductions in existing Federal programs, and resisting the establishment of new ones.

The concept was more inspired than the execution. The execution was in fact considerably blundered. Much too large a deficit was created. This deficit began to compound, and to assume a life of its own. In the first four years of the administration the national debt all but doubled, to a trillion and a half dollars. In the next four years another trillion dollars will be added.

One result is that interest payments on the debt have become the fastest growing item in the budget. In short order now, it will require a sum equal to half the revene of the personal income tax just to pay the interest on the debt, a transfer of wealth from labor to capital that I believe has no precedent in the annals of this Republic. In a situation where the real rate of interest is greater than the real rate of economic growth, the national debt compounds at an explosive rate. This is now the case and is likely to remain so for years.

If I describe the President's concept as inspired, it is not because I admire the way it is working out. I do not. The execution has been so mismanaged that soon or late it will lead to calamity, or so I believe. Consider that today, for the first time since 1914 when World War I led to the liquidation of European holdings over here, the United States has become a net debtor nation. We have dissipated our capital and could be on the verge of losing much of our industry. Even so, you have to admire the sweep of the Reagan revolution.

Not 16 years ago, as a member of the cabinet of another Republican President, I helped craft a legislative program which called for the Federal government to assume all the welfare costs of states and localities of the nation, to share its revenue with those states and localities, and to give them greater control over manpower programs. We adopted revenue sharing, a program designed to keep initiative alive at the state and local level. We got Supplemental Security Income (SSI), which asserts that social insurance is a national responsibility. Whatever else, the proposals reflected a feeling for Federalism. So this is not so much a matter of party tendency as the vision of one President, now in office.

I expect you will spend much of your meeting here talking about proposed Federal program cuts, and asking how to prevent them, or limit them. This is what you are supposed to be doing. The Republican leadership of the Senate is doing much the same. In all likelihood we will all still be doing this a decade hence.

There is an irony here. Because the debt has grown so great, the cost of the Federal Government, as a proportion of Gross National Product is now larger than it has ever been in peacetime history. But the domestic budget, especially the portion allocated to cities, is now under permanent pressure and will remain so. Small victories come in terms of programs kept from being cut, or cuts kept from being too great. As for the chance of major policy changes, my friend George Will recently estimated their likelihood as having gone from "not very" to "are you kidding?"

This is why I would take the opportunity presented by your invitation to draw attention to one subject, about which our cities can and ought to make a difference. I am talking about an event of constitutional dimension that has not yet happened, but may well do.

A year ago, in his State of the Union message, the President proposed to present Congress with a major overhaul of the tax system. This work was finished in November and published in three volumes, with the title: Tax Reform for Fairness, Simplicity, and Economic Growth.

In a hundred ways, the proposal is altogether admirable. Call it the pure theory of taxation. Call it a festschrift for Stanley Surrey, President Kennedy's renowned Assistant Secretary of the Treasury who preached the gospel of a tax code that would be neutral with respect to individual or corporate economic choices.

Part of the proposal, however, embodies a profound constitutional error, or so I believe. This is the proposal to eliminate the deduction of state and local taxes for the purpose of assessing Federal tax.

It would be the huge irony of Mr. Reagan's administration if, having started out to reduce the size of the Federal Government, he ended by putting in place a principle that can only vastly enlarge its scope, but that is what is at issue here.

The Framers of the Constitution had more thoughts about power than merely its limitation. They recognized and accepted the reality of the power embodied in government and they sought not only to ensure that it was limited, but to ensure also that it was shared. This was the system we call Federalism. It was not copied from anyone. It was wholly an American innovation, and it is precious.

In the debate to come, much is going to depend on our getting this straight in our heads. Federalism is not a managerial arrangement that the Framers hit upon because the country was big and there were no telephones. Federalism is not a form of decentralization with which large corporations occasionally experiment when things get clogged at the top. Federalism is not an arrangement of necessity forced upon the men at Philadelphia by the cantankerous parochialism of the Yankees and the Yorkers and the Southern gentry.

In some measure it was those things, but it was larger than any. As Daniel J. Elazar shows in the current issue of This World magazine, Federalism was a fundamental expression of the American idea of covenant.

Americans rejected "the notions of the general will and the organic state common among their European contemporaries." In our formal constitution, we opted instead for the principle declared in the Mayflower Compact, which is that we solemnly entered a covenant, one with the other, that we would govern together. The word "federal" derives from the Latin foedus, which Elazar tells us is simply the Latin for "covenant."

> This concept of covenant, of a lasting yet limited agreement between free men or between free families of men, entered into freely by the parties concerned to achieve common ends or to protect common rights, has its roots in the Hebrew Bible. There the covenant principle stands at the very center of the relationship between man and God and also forms the basis for the establishment of the holy commonwealth. The covenant idea passed into early Christianity only after losing its political implications. Its

> political sense was restored during the Protestant reformation, particularly by the Protestant groups influenced by Calvin and the Hebrew Bible, the same groups that dominated the political revolutionary movements in Britain and America in the seventeenth and eighteenth centuries. Much of the American reliance upon the covenant principle stems from the attempts of religiously-inspired settlers on these shores to reproduce that kind of covenant in the New World and to build their commonwealths upon it. The Yankees of New England, the Scotch-Irish of the mountains and piedmont from Pennsylvania to Georgia, the Dutch of New York, the Presbyterians, and to a lesser extent, the Quakers and German Sectarians of Pennsylvania and the Middle States were all nurtured in churches constructed on the covenant principle and subscribing to federal theology as the means for properly delineating the relationship between man and God (and, by extension, between man and man) as revealed by the Bible itself.

The essence of the Federal idea is that there are spheres of government which must not be invaded by other governments. Now this is not a rigid compartmentalization. All membranes in the Federal system are permeable. But they are not to be ripped. Nowhere is this more important than in the sphere of taxation, wherein the initiative and independence of different levels of government commences.

Yet this is what the Treasury proposal would do.

Last year, the deduction for state and local taxes reduced Federal taxes by $28.5 billion; in 1988, according to the Treasury, it would reduce Federal taxes by $34 billion. This is a large sum, and it introduces a question of first importance: how much the actual burden of state and local taxes would increase, if the deduction were repealed.

We don't have precise figures, but state and local governments raised, in round numbers, about $310 billion through taxes last year. The proposed change in the Federal tax code, then, would increase the real burden of these state and local taxes by about 10 percent.

The arithmetic is easy. The Federal deduction reduces the "real" cost of State and local taxes by upwards of 10 percent. For persons in higher tax brackets, the cost is correspondingly greater. This would certainly lead to a good deal of migration out of high tax jurisdictions, and indeed the Treasury proposal states outright that those who don't like the extra costs the administration proposal would impose, "are free to locate in the jurisdiction which provides the most amenable combination of public services and tax rates. Taxpayers have increasingly 'voted with their feet' in recent years." (Tax Reform for Fairness, Simplicity, and Economic Growth, Office of the Secretary, Department of the Treasury, p. 63.)

Last November, I wrote a short article on the subject for the Op-Ed page of The New York Times. My first draft began: "If you are looking for an apartment in Manhattan, help is on the way." On second thought I decided this was too alarmist, and took the sentence out. I wish now I hadn't.

The proposal will convulse the finances of school districts, that most quiet, efficient, and public-regarding of all levels of American government. And it will work perversely. More and more, the Nation will turn to the Federal government for the resources it needs, the very opposite of the principle of the Reagan Revolution. (In 1979, California passed Proposition 13 and had to cut local property taxes. The year previous, the state had contributed 40-to-45 percent of all local school district revenues. The year after, the State was called on to contribute 65-to-70 percent of all school funding.)

This also is the very opposite of the principle of Federalism. Nothing is so revealing as the language of the Treasury proposal. Over and again the deduction for state and local taxes is referred to as a Federal "subsidy":

> The deduction is sometimes defended as a subsidy ... There is no more reason for a Federal subsidy for spending by State and local governments than for private spending ... There is no reason to provide implicit Federal subsidies for spending of State and local governments by allowing deduction for their taxes ... Moreover, the deduction for State and local taxes is not an efficient subsidy ... In order to be even-handed and avoid (a) distributionally perverse pattern of subsidies, no itemized deductions should be allowed for taxes and fees paid to State and local governments.

The Treasury would have us believe the most fundamental activities of state and local governments are in some significant sense activities paid for by the Federal government.

A century ago we understood this. On July 1, 1862, President Lincoln signed the Revenue Act of 1862, the first national income tax, a 3-to-5 percent tax to finance the Union effort. Section 91 of that revenue Act said that "all other national, state and local taxes ... shall first be deducted" to determine a taxpayer's liability for the income tax -- and this under the most pressing emergency conditions our country ever has faced.

The then-chairman of the House Ways and Means Committee was Justin Smith Morrill. (In the same year, Representative Morrill wrote what we know as the "Morrill Act," providing Federal lands to establish state land grant colleges.)

Chairman Morrill, reporting the tax bill, explained that as a matter of simple logic, the deduction would be necessary both to avoid double taxation and to preserve a principle of Federalism:

> It is a question of vital importance that the General Government should not absorb all (the states') taxable resources -- that the accustomed objects of State taxation should, in some degree at least, go untouched ... Otherwise, we might perplex and jostle, if we did not actually crush, some of the most loyal States of the Union.

Will not this proposal perplex and jostle, if not actually crush? Will it not produce this huge and final irony: that the transfer of revenue resources to Washington inevitably concentrates more resources in the Federal Government, which will grow ever larger?

You don't have to accept this. What is at issue are your budgets, your basic services, and your fundamental relationship to the national government. All in the service of an abstract theory of taxation.

Yesterday, you passed a resolution on this issue. It begins:

> The provision of the Federal income tax code that allows taxpayers to deduct their state and local tax obligations from their Federal taxable income is a fundamental statement of the historical right of state and local governments to raise revenues and of individuals not to be double taxed.

The resolution describes this provision of the Federal income tax code as the largest single Federal "tax expenditure" item directly affecting cities.

Now "tax expenditure" is a term that implies that if the Federal government lets you keep some of your income, it is somehow giving you that income. A curious proposition from the present administration. But that's what it says: if we let you keep it, it's something we've given you; it somehow belonged to us in the first place.

I don't believe this. I don't think that's what they had in mind in Philadelphia in 1787. I don't think you should call it a tax expenditure, and I don't think you should let the Treasury get away with calling it a Federal "subsidy." In diplomacy this is known as semantic infiltration: if the other fellow can get you to use his words, he wins.

I began on a large theme and will close on one. Thirteen days after Mr. Reagan stated his theory of Federal spending, he presented an equally large proposition about Federal taxes. In an address to a Joint Session of Congress on February 18, 1981, he said:

> The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change.

May I offer the view that this is not possible? It sounds good. It doesn't happen. Any tax affects the economy and changes society: a little bit, a lot, something in-between.

A "neutral" tax proposal such as the Treasury has offered will have pervasive effects on the economy and the society. There is no avoiding this; only disguising it. I happen to prefer John F. Kennedy's formulation, that to govern is to choose, and I would choose not to assault Federalism in the manner the Treasury proposes.

TESTIMONY OF

THE HONORABLE RAYMOND J. McGRATH

FIFTH DISTRICT - NEW YORK

SUBMITTED FOR THE RECORD OF THE HEARING

BEFORE THE SUBCOMMITTEE ON ECONOMIC STABILIZATION,

HOUSE COMMITTEE ON BANKING, FINANCE & URBAN AFFAIRS

MAY 23, 1985

Mr. Chairman and members of the Subcommittee, I want to thank you for this opportunity to present my views on the proposed elimination of the deduction for state and local taxes.

I view the elimination of this deduction as the single most damaging element in the various tax reform proposals. It would have a devastating impact on the ability of state and local governments to raise the funds necessary to provide services at these lower levels of government.

The deductibility of state and local taxes has a long history, going all the way back to 1861, when an emergency income tax was enacted to finance the Civil War. In subsequent income taxes enacted since that time, state and local taxes have remained deductible.

Over the last four years, we have made great strides in reasserting the role of state and local government in our federal

SYSTEM. WHILE SOME OF THE PRESIDENT'S GOALS IN THIS AREA HAVE NOT RECEIVED STRONG BIPARTISAN SUPPORT, FEW WOULD QUESTION THE FACT THAT CONGRESS AND THE ADMINISTRATION HAVE CHARTED A NEW COURSE WITH GREATER RESPONSIBILITIES SHIFTED TO LOWER LEVELS OF GOVERNMENT.

THE ABILITY OF STATES AND LOCALITIES TO PROPERLY ADDRESS NEW CHALLENGES IS DIRECTLY RELATED TO THEIR CAPACITY TO RAISE SUFFICIENT REVENUE. THIS IS NEVER AN EASY TASK, PARTICULARLY IN MUNICIPALITIES WHERE OFFICIALS ARE OFTEN DIRECTLY PRESSURED IN FACE TO FACE MEETINGS WITH CONSTITUENTS ANGERED OVER THE SPECTRE OF HIGHER TAXES. NEVERTHELESS, MANY ESSENTIAL SERVICES RANGING FROM INFRASTRUCTURE MAINTENANCE TO MEDICAID HAVE BEEN FUNDED WITH GREATER CONTRIBUTIONS RAISED BY STATE AND LOCAL GOVERNMENT.

RECENT STATEMENTS BY OFFICIALS OF THE TREASURY DEPARTMENT CLEARLY INDICATE THAT WE FACE AN APPARENT REVERSAL IN THE PRESIDENT'S LONGSTANDING COMMITMENT TO STRENGTHENING THE POWER OF LOWER LEVELS OF GOVERNMENT. STAUNCH SUPPORT FOR ELIMINATION OF

THE PERSONAL INCOME TAX DEDUCTION FOR STATE AND LOCAL TAXES IS AN INDICATION THAT SOME TREASURY OFFICIALS WISH TO ABANDON A PARTNERSHIP WITH OTHER UNITS OF GOVERNMENT IN THE OVERALL EFFORT TO FULFILL OUR RESPONSIBILITIES TO THE AMERICAN PEOPLE.

IN THE PAST, THE DEDUCTION FOR STATE AND LOCAL TAXES HAS AVOIDED OPPRESSIVE DOUBLE TAXATION BY EXCLUDING AMOUNTS LEVIED BY OTHER ELECTED OFFICIALS FROM THE AMOUNT TAXED BY THE FEDERAL GOVERNMENT. THE TREASURY PROPOSAL CHANGES THIS TENET OF FEDERALISM. IT WILL CREATE HARDSHIP FOR OTHER OFFICIALS, WHO ARE LIKELY TO TURN AGAIN TO THE FEDERAL GOVERNMENT FOR ASSISTANCE IN MEETING PRESSING PUBLIC NEEDS. THUS, THE EFFORTS OF THE REAGAN ADMINISTRATION AND CONGRESS TO RESTORE A BALANCE AMONG VARIOUS UNITS OF GOVERNMENT WILL BE THWARTED.

IN ADDITION TO ABANDONING THE EFFORTS TOWARD NEW FEDERALISM, THE ELIMINATION OF THE DEDUCTION WILL HAVE A DISPROPORTIONATE IMPACT ON DIFFERENT AREAS OF THE COUNTRY. IN EFFECT, ELIMINATION OF THE DEDUCTION PENALIZES THOSE STATES AND LOCALITIES WHO PROVIDE

THE MOST SERVICES FOR THEIR RESIDENTS. IN PARTICULAR, LOSS OF DEDUCTIBILITY PENALIZES TAXPAYERS IN URBAN AREAS:

•URBAN AREAS TEND TO HAVE LARGER NEEDY POPULATIONS AND THEREFORE REQUIRE MORE SERVICES. LOSS OF THE DEDUCTION WILL RESULT IN LOCAL TAXPAYERS EXERTING PRESSURE FOR TAX REDUCTIONS WHICH WILL IN TURN RESULT IN CUTS IN SERVICES TO THESE INDIGENT POPULATIONS.

•COSTS TO PROVIDE SERVICES ARE HIGHER IN URBAN AREAS AND THEREFORE TAXES MUST BE HIGHER TO PROVIDE NECESSARY SERVICES.

I AM PARTICULARLY CONCERNED OVER THE IMPACT OF THIS PROPOSAL ON EDUCATION, WHICH IS PERHAPS THE MOST SACRED OF ALL LOCAL FUNCTIONS. SINCE EDUCATION IS THE LARGEST SINGLE EXPENDITURE OF STATE AND LOCAL GOVERNMENTS, A LARGE SHARE OF THE EXPENDITURE REDUCTIONS MADE TO MINIMIZE THE FEDERAL TAX INCREASE WOULD BE BORNE BY EDUCATION. WE MUST NOT ALLOW THIS TO HAPPEN. A WELL

EDUCATED AND INFORMED PUBLIC IS ESSENTIAL FOR ECONOMIC COMPETITION AND THE LONG TERM SECURITY AND DEFENSE OF THE NATION.

EARLIER THIS YEAR, I INTRODUCED H. RES. 105, WHICH EXPRESSES THE SENSE OF THE HOUSE THAT THE DEDUCTION FOR STATE AND LOCAL TAXES SHOULD NOT BE REPEALED. I AM PLEASED TO REPORT THAT 57 OF MY COLLEAGUES HAVE JOINED ME IN SPONSORING THIS RESOLUTION WHICH PUTS THE FRAMERS OF TAX REFORM ON NOTICE THAT WE WANT TO PROTECT THE AMERICAN TAXPAYER FROM EROSION OF THEIR INCOME THROUGH LOSS OF THIS IMPORTANT DEDUCTION.

IN CONCLUSION, I WOULD LIKE TO QUOTE THE DISTINGUISHED FORMER RANKING MINORITY MEMBER OF THE WAYS AND MEANS COMMITTEE, BARBER CONABLE. I THINK HE SUMMED UP THE ISSUE QUITE WELL WHEN HE WROTE, "TO BE A RELATIVE WINNER IF THE DEDUCTION IS ELIMINATED, YOU BETTER LIVE IN A LOW-TAX, NATURAL RESOURCE PRODUCING STATE WITH RENT CONTROL. DO NOT OWN YOUR OWN HOME AND DO PREFER CENTRAL GOVERNMENT TO STATE AND LOCAL CONTROL."

Statement of the Honorable Norman D. Shumway
May 23, 1985

Economic Stabilization Subcommittee Hearing on the Regional Economic Effects of Elimination of the Deduction For State and Local Taxes

Thank you, Mr. Chairman. I join you in welcoming our distinguished panel of witnesses today, including a compatriot of yours from the State of New York, Senator D'Amato.

I think there will be little disagreement between both sides of the aisle today as we consider the economic effects of Treasury's plan to repeal the Federal tax deduction for state and local property, sales, and income taxes. In fact, I am sure that our assessment of the proposal will be uniform.

The deduction for State and local taxes is not a tax preference or incentive. It was not included as part of the original Federal income tax act as a means to foster a particular national economic or social objective. Since 1913, Congress has recognized -- indeed, intended -- that American citizens not be subject to double taxation. The deductibility of State and local taxes reflects this intent.

More importantly, the deduction is the cornerstone of the principle of Federalism, on which this country is based. Our system of government is founded on the principle of mutual reciprocity. At the national level, we have instituted a Federal income tax to generate the revenues necessary to provide for national needs, be they defense, transportation, education or basic services for the needy. At the same time, Congress has delegated to State and local governments the authority to impose taxes to provide for the specific needs of their residents at that level.

While it may be true that, to some extent, certain national and state services may overlap or be duplicative. However, that is not the issue. The real issue is that never before in its history has the Federal government taxed its citizens on the taxes they have paid for benefits and services received at the State and local level.

I believe double taxation is wrong. And I certainly don't buy the argument that the Federal government is subsidizing high-income taxpayers or high-tax states through this deduction. I would like to submit for the record an article entitled, "Tax Reform: Who'd Be Hurt If It Passes," in the May 6, 1985 issue of U.S. NEWS AND WORLD REPORT. The article provides the latest estimates of how the benefits of this deduction are spread among Americans, depending on their income. Interesting enough, the statistics reveal that taxpayers in the $30-50,000 income bracket use the deduction more than any other income bracket. If this is the so-called high-income taxpayer, I would hate to see how Treasury classifies "low-income."

Although I do have some concerns regarding the higher tax rates of certain States relative to others, I think we must recognize that these States may have special or unique funding requirements which may entail this level of assessment on their residents. Before wiping the slate clean through elimination of the deduction, I think we should consider these States' tax rates in light of their particular situations. To use the old phrase, I would hate to see us be "the fools who rush in where angels fear to tread."

Finally, I believe we must consider this issue in light of this Administration's program of federalism. I believe in the program and the need for States to assume more of the fiscal responsibility for its residents, particularly given the inordinate size of the federal deficit. I am heartened to see that States have pledged their support in this effort. But, at a time when we are asking the States -- and our taxpayers -- to play a larger role in sharing the cost of services to all American, we cannot remove the means by which they do so. Nor can the federal government benefit through this process.

Finance

Tax Reform: Who'd Be Hurt If It Passes

Officials are discovering nearly everywhere they turn that someone wants to keep a favorite deduction.

New figures from Congress show why lawmakers are wary of voters' reactions to proposed tax reforms: Tens of millions of Americans in all income classes would lose favored tax breaks.

Affected most would be filers of the more than 35 million individual returns with itemized deductions—mostly middle and upper-income people.

In all, estimates the staff of Congress's Joint Committee on Taxation, tax breaks to individuals under current law will cost Uncle Sam some 300 billion dollars in lost revenue in the 1986 fiscal year, starting October 1. Corporations would account for an additional 120 billion.

Because of such stakes, members of Congress as well as the Reagan administration already are feeling the heat from lobbying groups who want to hold on to their deductions. The pressure is sure to pick up after President Reagan sends his reform plan to Capitol Hill, probably within a few weeks.

Not all of today's deductions would be wiped out, to be sure. In its reform plan sent to Reagan last November, for instance, the Treasury would continue to let individuals deduct mortgage interest on principal homes. Present medical-expense deductions would remain, too, as would today's rules on limited taxation of Social Security benefits. What's more, tax rates would be cut for nearly everyone.

Nevertheless, as tables on this page indicate, there will be plenty of fuel for complaints. Nearly 25 million returns save 15 billion dollars with state and local income-tax deductions. Upper-income people making more than $50,000 a year gain nearly 16 billion from favorable tax treatment of capital gains.

At the other end of the income scale, the elderly with incomes of less than $20,000 a year are the bulk of the gainers from the present extra tax exemption for persons 65 or older. ☐

Where Today's Tax Breaks Go

Here are the latest estimates of how the benefits of key individual federal income-tax deductions are spread among Americans, depending on their income.* Figures are based on 1985 tax law applied to 1983 income-tax returns—

Some That May Be Killed by Tax Reform

Sales-Tax Deduction

Income	Returns	Amount
Below $20,000	4,760,000	$ 220 mil.
$20,000-$30,000	7,441,000	$ 626 mil.
$30,000-$50,000	11,289,000	$1,730 mil.
$50,000-$100,000	3,816,000	$1,142 mil.
Over $100,000	747,000	$ 465 mil.

Income-Tax Deduction

Income	Returns	Amount
Below $20,000	3,945,000	$ 334 mil.
$20,000-$30,000	6,815,000	$1,403 mil.
$30,000-$50,000	10,130,000	$4,843 mil.
$50,000-$100,000	3,344,000	$4,219 mil.
Over $100,000	676,000	$4,433 mil.

Real-Estate-Tax Deduction

Income	Returns	Amount
Below $20,000	3,633,000	$ 392 mil.
$20,000-$30,000	6,353,000	$1,003 mil.
$30,000-$50,000	10,313,000	$2,898 mil.
$50,000-$100,000	3,677,000	$2,132 mil.
Over $100,000	713,000	$1,067 mil.

Charitable-Contributions Deduction

Income	Returns	Amount
Below $20,000	4,096,000	$ 386 mil.
$20,000-$30,000	6,889,000	$ 978 mil.
$30,000-$50,000	11,022,000	$2,862 mil.
$50,000-$100,000	3,887,000	$2,360 mil.
Over $100,000	683,000	$3,586 mil.

Capital-Gains Exclusion

Income	Returns	Amount
Below $20,000	815,000	$ 795 mil.
$20,000-$30,000	113,000	$ 890 mil.
$30,000-$50,000	589,000	$ 1,913 mil.
$50,000-$100,000	990,000	$ 2,919 mil.
Over $100,000	380,000	$12,741 mil.

Extra Exemption for Elderly

Income	Returns	Amount
Below $20,000	294,000	$ 1,161 mil.
$20,000-$30,000	1,547,000	$ 441 mil.
$30,000-$50,000	1,111,000	$ 454 mil.
$50,000-$100,000	485,000	$ 279 mil.
Over $100,000	178,000	$ 129 mil.

Child-Care Credit

Income	Returns	Amount
Below $20,000	1,224,000	$ 565 mil.
$20,000-$30,000	1,452,000	$ 504 mil.
$30,000-$50,000	1,870,000	$ 605 mil.
$50,000-$100,000	414,000	$ 156 mil.
Over $100,000	32,000	$ 12 mil.

And Two That May Survive

Home-Mortgage-Interest Deduction

Income	Returns	Amount
Below $20,000	3,516,000	$ 1,057 mil.
$20,000-$30,000	5,840,000	$ 2,956 mil.
$30,000-$50,000	9,406,000	$ 7,883 mil.
$50,000-$100,000	3,111,000	$ 5,184 mil.
Over $100,000	568,000	$ 1,877 mil.

Medical Deduction

Income	Returns	Amount
Below $20,000	2,865,000	$ 493 mil.
$20,000-$30,000	2,649,000	$ 641 mil.
$30,000-$50,000	2,258,000	$ 786 mil.
$50,000-$100,000	499,000	$ 382 mil.
Over $100,000	58,000	$ 223 mil.

[illegible]

Chairman LAFALCE. Now, I understand that Congressman Kanjorski has a statement that he would like to make.

Congressman Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

The issue before this subcommittee today is the impact of the elimination of the Federal tax deduction on State and local taxes.

It is of vital importance to those of us who were closely elected officials in our districts and who care about the level of taxes paid by our constituents. The need for tax simplification is great and immediate. Its effects, however, are equally great, and we must carefully weigh the pros and cons of each change so that we do not make any precipitous changes which we would later regret.

I believe that the facts conclusively prove that the elimination of the deduction for State and local taxes would be bad public policy, particularly for the residents of States like Pennsylvania.

Pennsylvania is a relatively high tax State. It is a high tax State because our cost of living is higher than many other States and because our citizens need the economic development programs that State and local revenues provide. Our citizens need new jobs, and they are willing to tax themselves to attract new jobs and industry to the State.

According to the Advisory Commission on Intergovernmental Relations, the average Pennsylvanian saves roughly $800 on his Federal taxes as a result of being able to deduct his State and local taxes.

If this exemption is abolished, not only will the average Pennsylvanian be paying more—considerably more—in taxes, but he will be paying a tax on a tax. Individuals would have to pay Federal income taxes on income they had already turned over to State and local governments to pay State and local taxes.

This is a new form of double jeopardy. In addition, numerous studies have shown that States such as Pennsylvania now pay more in Federal taxes than they receive back in Federal expenditures.

The elimination of State and local tax deductibility would further distort this disparity. While the rich become richer, the poor would become poorer.

Elimination of the State and local deduction would have the immediate effect of raising Federal revenues an estimated $29 billion in fiscal year 1985. At the same time, however, it would probably result in pressure to reduce State and local taxes or to cut services.

I have been contacted by many of the local officials in my district who have informed me that they would have to reduce services if they cut taxes, and this would come after several years of substantial reductions in Federal assistance to local communities.

The real value of Federal aid to State and local governments was cut by 2 percent in 1979, 5 percent in 1981, and 12 percent in 1982. The administration's current budget proposes further cuts in Federal aid by $10 billion in fiscal year 1986 and $97 billion between now and 1990.

The decade of the eighties will have seen a reduction in Federal aid to State and local governments of some $130 billion.

The proposal to eliminate revenue sharing and to reduce many economic development programs threaten to further undermine the situation facing local governments, particularly in economically depressed areas like northeastern Pennsylvania. In the 11th District of Pennsylvania alone, eliminating revenue sharing will cost local governments more than $10 million and could cause local property taxes to increase an average of 87 percent if the local property tax is used to replace lost Federal revenues.

Eliminating the deductibility of State and local taxes is like adding insult to injury if we are also to reduce Federal aid to States and localities. If local property taxes have to increase 87 percent in order to replace lost revenue-sharing funds, I doubt that there are many people in the 11th District of Pennsylvania who want to eliminate the deductibility of local property taxes.

First, we cut their Federal aid, then we raise their local taxes to make up for the loss of Federal aid, and then we raise their Federal taxes by preventing them from deducting their State and local taxes. Is that fair?

I honestly do not believe that we should expect local taxpayers and local officials, most of whom have done an excellent job under the most trying circumstances over the past 6 years, to once again be the scapegoats for the Federal Government.

In addition, I believe it is bad public policy to levy a tax on a tax. That runs totally contrary to the principle established by our Founding Fathers that State and local governments should not tax the Federal Government, and the Federal Government should not tax State and local governments.

The elimination of the deductibility of State and local taxes is bad public policy both for northeastern Pennsylvania and for the Nation as a whole.

I welcome the testimony of our witnesses today because I believe their testimony will conclusively prove that this is an idea whose time has not yet come.

Thank you.

Chairman **LaFalce**. Thank you very much, Representative Kanjorski.

We will now hear from the panelists, and I would like the panelists to come to the witness table.

Our first witness will be Hon. Daniel E. Griset, mayor of the city of Santa Ana, CA, representing the National League of Cities and the U.S. Conference of Mayors.

Mayor Griset.

STATEMENT OF HON. DANIEL E. GRISET, MAYOR, CITY OF SANTA ANA, CA, REPRESENTING THE NATIONAL LEAGUE OF CITIES AND THE U.S. CONFERENCE OF MAYORS

Mr. **Griset**. Good morning, Mr. Chairman.

Chairman **LaFalce**. We will put the entire text of your testimony in the body of the record, and you may feel free to summarize it, if that is your desire.

Mr. **Griset**. Good morning, Mr. Chairman and members of the subcommittee. My name is Dan Griset. I am the mayor of Santa Ana, CA, and I sit on the board of the National League of Cities, the oldest and largest organization representing municipalities in the country.

I am testifying this morning on behalf of the 15,000 direct and indirect members of our organization and on behalf of the U.S. Conference of Mayors.

I am here to testify on an issue of great concern to city officials. At our Congressional City Conference this March, our board of directors determined that maintaining the deductibility of State and local taxes from the Federal individual income tax is essential to enable cities to continue to provide necessary services and to comply with Federal mandates.

The policy position we took at our March meeting is similar to the policy of the Conference of Mayors.

As you know, Mr. Chairman, 1985 marks a year when cities will be asked to assume major new unfunded responsibilities. It is a year in which both direct and indirect Federal assistance is going to be cut sharply.

The Congress proposed to eliminate our single most important program to help respond to fiscal distress—general revenue sharing. It has proposed cuts in almost all other direct assistance programs.

The administration and Senate, in addition, have proposed deep cuts in indirect assistance. By that, I mean they have proposed cuts in Medicaid, child nutrition, and other programs targeted to low income Americans.

Because cities are the level of government of last resort for those who are hungry, homeless, or in need of urgent medical assistance, these are human mandates we will have to assume. They are unfunded liabilities.

At the same time, Mr. Chairman, the continuing stream of Federal mandates goes on. To add to the growing list of Federal court decisions mandating expensive local compliance on matters such as the construction of new prisons and mental health care facilities, the recent Supreme Court decision in the *San Antonio* case will add a whole new layer of unfunded liabilities for virtually every city.

In effect, one could say that the Congress has accepted a version of the original administration federalism proposal; that is, cutting off most Federal assistance and turning over a host of responsibilities to State and local governments.

There is, however, one enormous and disturbing difference. As originally proposed, the new federalism proposal recognized the extraordinary cost burdens that would impose on State and local governments. Consequently, the original administration proposal advocated turning back a number of revenue sources to cities and States to pay for these heretofore Federal responsibilities.

Now, this time that part of the proposal is not only absent, but in its place has been substituted a proposal which will make it harder for us to raise our own taxes.

In the desire to find sources of revenue with which to lower the top tax bracket, the Treasury has linked the deductibility of State and local taxes up with a long list of tax subsidies and preferences without distinguishing either the historical role of deductibility or its existence in the Constitution and Internal Revenue Code—not as a tax shelter, but as an integral part of our federal system.

The deductibility of State and local taxes has been a part of the U.S. income tax system since the system's inception in 1913. Moreover, the concept of reciprocity has been an ingredient of federalism in our Constitution. In large part, reciprocity has been the cornerstone of our federal system.

Just as cities are prohibited from imposing property taxes on Federal land, even though we must provide the same level of services as we do to all other property owners within our cities, and just as we are prohibited from treating the interest earned on Federal securities as income for tax purposes, so, too, the Federal Government has not in the past proposed to impose a tax on our taxes or on our securities backed with our taxing power's full faith and credit.

Whether this is called comity or federalism, the point is the same. Our system of Government is intended to be mutually reinforcing, not predatory and preemptive.

To be honest, Mr. Chairman, we are confused by a proposal which has the appearance of setting a double standard. That is, it seems to say that it is all right for the Federal Government to deduct its 13 million dollars' worth of property tax liabilities to Los Angeles, but it is not OK for property taxpayers in Los Angeles to deduct their property taxes from their Federal income taxes.

While the tax reform proposal would partially compensate some individual taxpayers for the loss of the ability to deduct State and local tax payments from Federal income tax liability by lowering marginal tax rates, State and local governments would not be similarly compensated.

In addition to the loss of deductibility, our cities will continue to lose revenues through such federally mandated tax subsidies, such as the exemption of Federal property from local property taxes.

Thus, the President's tax reform proposal appears to set a double standard and ignores the constitutional protection and taxing authority granted to cities. The elimination of the State and local tax deduction could be seen in direct conflict with the principles of Federalism and reciprocal immunity.

In essence, the elimination would severely affect the cities' ability to provide services, especially the ability to implement the many federally mandated programs, including Medicaid, nutrition, and services to the homeless, which account for much of the current high levels of taxation, especially in inner cities.

For it is in its elimination of State and local tax deductibility that the tax reform proposal is least sympathetic to areas with high service demands. As the Federal Government curtails funding for services, cities must provide the safety net. We provide, for example, the 9-1-1 service. Not only must we provide the net, but we are compelled to provide it through our own tax revenues.

Central cities in urban States must provide the safety net for the most dependent of our citizens who have been left isolated by urban flight. These cities are faced with high levels of service demand caused by such factors as the high numbers of foreign immigrants who must be provided with services to assist their integration into the American social and economic system.

These cities in particular must respond to the high levels of overcrowded, antiquated, and inadequate housing and the high numbers of impoverished households headed by females with dependent children. Not only do these cities have to pay for significantly higher service costs per capita, but they have a more limited revenue base from which to draw.

States such as California, my own, where large reliance is placed on progressive systems of income taxation and where regressive forms of taxation like the property tax have been limited, are penalized.

While it is estimated that the loss of deductibility would cause State and local government revenues to fall by $12.4 billion directly, there are other side effects in addition.

All cities issue general obligation bonds for the construction and operation of municipal infrastructure. These bonds are backed by our taxing authority. Yet, as this taxing authority is adversely affected by this tax proposal to discourage and disadvantage State and local taxes, it will lower bond ratings and increase our cost of borrowing.

Although it is difficult to quantify the impact of the repeal of deductibility on a city-by-city basis, we are especially concerned that cities would lose jobs and taxpayers to lower tax suburbs.

Cities tend to provide a disproportionate amount of services, requiring higher taxes, not only because they must serve nonresidents during working hours but also because they tend to have disproportionately higher levels of persons in need.

The economic base of the higher tax cities would be weakened. As these cities lose their own capacity to finance essential social services, the needy and the poor will suffer, and the cycle will become more vicious in time.

As the Federal Government continues to transfer to cities the responsibility of programs to aid the poor and needy and as the Congress puts together a budget package that would in essence leave cities alone with the growing fiscal responsibility for education, housing, infrastructure, health care, and other programs, it seems like a double whammy that the tax reform proposal, instead of helping cities meet their own revenue needs to assume Federal responsibilities and replace Federal assistance, appears to penalize the cities of this Nation for struggling to meet their own needs through responsible and necessary revenue measures by this proposal to eliminate deductibility.

Mr. Chairman, the National League of Cities has conducted an extensive and I think very informative study of the issue of the deductibility of State and local taxes, and we would like to incorporate this in the record of the subcommittee as a reference on this important issue.

That concludes my testimony.

Chairman LAFALCE. Without objection, so ordered.

Thank you very much, Mayor, for your presentation on behalf of both the National League of Cities and the U.S. Conference of Mayors.

[The prepared statement of Mayor Griset on behalf of the National League of Cities and U.S. Conference of Mayors follows:]

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STATEMENT OF

THE HONORABLE DAN GRISET

MAYOR, SANTA ANA, CALIFORNIA

on behalf of

THE NATIONAL LEAGUE OF CITIES

and

THE U.S. CONFERENCE OF MAYORS

on

DEDUCTIBILITY OF STATE AND LOCAL TAXES

before

SUBCOMMITTEE ON ECONOMIC STABILIZATION

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

May 23, 1985

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STATEMENT

OF

DAN GRISET, MAYOR OF SANTA ANA, CALIFORNIA

FOR THE

NATIONAL LEAGUE OF CITIES

AND

U.S. CONFERENCE OF MAYORS

MAY 23, 1985

Good morning, Mr. Chairman and members of the subcommittee, my name is Dan Griset. I am the Mayor of Santa Ana, California and I sit on the Board of the National League of Cities, the oldest and largest organization representing municipalities in the country. I am testifying this morning on behalf of the 15,000 direct and indirect members of our organization, and on behalf of the U.S. Conference of Mayors.

I am here to testify on an issue of great concern to city officials. At our Congressional-City Conference this March, our Board of Directors determined that maintaining the deductibility of state and local taxes from the federal individual income tax is essential to enable cities to continue to provide necessary services and to comply with federal mandates. The policy position we took at our March meeting is similar to the policy of the Conference of Mayors.

As you know Mr. Chairman, 1985 marks a year when cities will be asked to assume major new, unfunded responsibilities. It is a year in which both direct and indirect federal assistance are going to be cut sharply. The Congress has proposed to eliminate our single most important program to help respond to fiscal distress, General Revenue Sharing. It has proposed cuts in almost all other direct assistance programs. The administration and Senate, in addition, have proposed deep cuts in indirect assistance. By that I mean they have proposed cuts in Medicaid, child nutrition, and other programs targeted to low income Americans. Because cities are the level of government of last resort for those who are hungry, homeless, or in need of urgent medical assistance; these are human mandates we will have to assume. They are unfunded liabilities.

At the same time, Mr. Chairman, the continuing stream of federal mandates goes on. To add to the growing list of federal court decisions mandating expensive local compliance on matters such as the construction of new prisons and mental health care facilities, the recent Supreme Court decision in the San Antonio case will add a whole new layer of unfunded liabilities for virtually every city.

In effect, one could say that the Congress has accepted a version of the original administration federalism proposal, that is cutting off most federal assistance and turning over a host of responsibilities to state and local governments. There is, however, one enormous and disturbing difference: as originally proposed, the new federalism proposal recognized the extraordinary cost burdens it would impose on state and local governments. Consequently, the original administration proposal advocated turning back a number of revenue sources to cities and states to pay for these heretofore federal responsibilities. Now, this time, that part of the proposal is not only absent, but in its place has been substituted a proposal which will make it harder for us to raise our own taxes.

In the desire to find sources of revenue with which to lower the top tax bracket, the Treasury has linked the deductibility of state and local taxes up with a long list of tax subsidies and preferences--without distinguishing either the historical role of deductibility or its existence in the Constitution and Internal Revenue Code, not as a tax shelter, but as an integral part of our federal system.

The deductibility of state and local taxes has been a part of the U.S. income tax system since the system's inception in 1913. Moreover, the concept of reciprocity has been an ingredient of Federalism in our Constitution. In large part, reciprocity has been the cornerstone of our federal system.

Just as cities are prohibited from imposing property taxes on federal land--even though we must provide the same level of services as we do to all other property owners within our cities--and just as we are prohibited from treating the interest earned on federal securities as income for tax purposes, so too the federal government has not in the past proposed to impose a tax on our taxes or on our securities backed with our taxing power's full faith and credit. Whether this is called comity or federalism, the point is the same, our system of government is intended to be mutually reinforcing, not predatory and preemptive.

To be honest, Mr. Chairman, we are confused by a proposal which has the appearance of setting a double standard. That is, it seems to say that it is all right for the federal government to deduct its $13 million worth of property tax liabilities to Los Angeles, but it is not o.k. for property tax payers in Los Angeles to deduct their property taxes from their federal income taxes.

While the tax reform proposal would partially compensate some individual taxpayers for the loss of the ability to deduct state and local tax payments from federal income tax liability by lowering marginal tax rates, state and local governments would not be similarly compensated. In addition to the loss of deductibility, our cities will continue to lose revenues through such federally mandated tax subsidies such as the exemption of federal property from local property taxes.

Thus the President's tax reform proposal appears to set a double standard and ignores the constitutional protection and taxing authority granted to cities. The elimination of the state and local tax deduction could be seen in direct conflict with the principles of federalism and reciprocal immunity. In essence, the elimination would severely effect the cities' abilities to provide services, especially the ability to implement the many federally mandated programs, including medicaid, nutrition, and services to the homeless which account for much of the current high levels of taxation, especially in inner cities.

For it is in its elimination of state and local tax deductibility that the tax reform proposal is least sympathetic to areas with high service demands. As the Federal government curtails funding for services, cities must provide the safety net. We provide the 9-1-1 service. Not only must we provide the net, but we are compelled to provide it through our own tax revenues. Central cities in urban states must provide the safety net for the most dependent of our citizens who have been left isolated by urban flight. These cities are faced with high levels of service demand caused by such factors as the high numbers of foreign immigrants who must be provided with services to assist their integration into the American social and economic system. These cities, in particular, must respond to the high levels of overcrowded, antiquated and inadequate housing and the high numbers of impoversihed households headed by females with dependent children. Not only do these cities have to pay for significantly higher service costs per capita, but they have a more limited revenue base from which to draw.

States such as California, where large reliance is placed on progressive systems of income taxation and where regressive forms of taxation like the property tax have been limited, are penalized.

While it is estimated that the loss of deductibility would cause state and local government revenues to fall by $12.4 billion directly, there are other side effects in addition. All cities issue general obligation bonds for the construction and operation of municipal infrastructure. These bonds are backed by our taxing authority. Yet, as this taxing authority is adversely impacted by this tax proposal to discourage and disadvantage state and local taxes, it will lower bond ratings, and increase our cost of borrowing.

Although it is difficult to quantify the impact of the repeal of deductibility on a city by city basis, we are especially concerned that cities would lose jobs and taxpayers to lower tax suburbs. Cities tend to provide a disproportionate amount of services--requiring higher taxes--not only because they must serve non-residents during working hours, but also because they tend to have disproportionately higher levels of persons in need. The economic base of the higher tax cities would be weakened. As these cities lose their own capacity to finance essential social services, the needy and the poor will suffer. The cycle will become more vicious.

As the federal government continues to transfer to cities the responsibility of programs to aid the poor and needy and as the Congress puts together a budget package that would in essence leave cities alone with the growing fiscal responsibility for education, housing, infrastructure, health care and other programs, it seems like a double whammy that the tax reform proposal--instead of helping cities meet their own revenue needs to assume federal responsibilities and replace federal assistance--appears to penalize the cities of this nation for struggling to meet their own needs through responsible and necessary revenue measures by eliminating deductibility.

Chairman LAFALCE. We will now hear from Dr. Louis Stettler, the budget director for the State of Maryland, speaking on behalf of the National Association of State Budget Officers.

Dr. Stettler.

STATEMENT OF DR. H. LOUIS STETTLER III, SECRETARY OF THE MARYLAND DEPARTMENT OF BUDGET AND FISCAL PLANNING, REPRESENTING THE NATIONAL ASSOCIATION OF STATE BUDGET OFFICERS

Dr. STETTLER. Good morning, Mr. Chairman, members of the subcommittee. I am Louis Stettler. I am the budget director of the State of Maryland, and I am here on behalf of the National Association of State Budget Officers.

Chairman LAFALCE. Could you speak a bit more into the microphone, please?

Dr. STETTLER. Yes.

I have submitted written testimony and I would only summarize this.

As you said earlier, Mr. Chairman, deductibility of State and local taxes from Federal taxable income has been a part of the U.S. income tax system, not only since it was enacted in 1913 but in our prior efforts during the Civil War.

The long history of State and local tax deductibility does not by itself prove that it should be maintained but that there are many important reasons why it has been in existence for so long and why it should be continued to remain as a major component of the Federal income tax.

Before I elaborate on a number of these important reasons, I would like to make one point. State and local governments are not just another special interest group. State, city, county, school district, and the Federal Government all work together under the federal system to provide a responsible intergovernmental network that is responsive to the needs of the people. There is a big difference between providing food to needy children and a three-martini lunch, between providing transportation to public schools and business trips to the Super Bowl, between medical assistance to the poor and health club memberships for executives.

State and local governments are in the same business as the Federal Government. Elected officials are trying to provide needed public services to the people in a very efficient way.

The testimony that I've presented has six reasons which we believe are important reasons both in the historical context and for the future.

First, the fiscal federalism that has developed in the United States is basically designed to provide coordination between the different levels of government. Without links between these different levels of government, the competition for tax revenue would place State and local governments at a disadvantage compared to the Federal Government and would impede their efforts to provide certain public goods that are best provided by the State or local government level.

Deductibility has served as one important link in this intergovernmental system. To reverse this policy would have severe consequences. State and local governments' ability to balance their budgets would be made more difficult at the same time they are being asked by the Federal Government to become the prime provider of many domestic services.

Second, deductibility of State and local income taxes also adds fairness, a goal of tax reform, to the intergovernmental tax system. As the Senator from New York has stated, it prevents double taxation. The issue also relates to the principle that individuals should be taxed according to their ability to pay, a principle which the Federal income tax has long adherred to, and which deductibility serves.

Third, the State and local tax deductibility is a feature of the income tax that is shared by many across this country. According to the "1982 Statistics of Income," published by the Internal Revenue Service, 51 percent of all returns deducting State and local income taxes were from people earning less than $30,000, and 87 percent were from people with incomes less than $50,000. It is not a benefit of solely the rich; it has a very broad middle-class application. In addition, more taxpayers claim the State and local tax deduction than the home mortgage interest deduction.

In 1982, 33 million taxpayers claimed the State and local deduction. That is substantially more than claimed the home mortgage interest which is being retained. The State and local tax deduction is a much broader based deduction.

Fourth, deductibility helps maintain a fiscal balance between the levels of government by effectively lowering the relative prices of services provided by State and local governments. The removal of deductibility of State and local taxes will increase the net cost to the taxpayer of State and local taxes; yet, the amount of needed State and local services would not change. The loss, therefore, of deductibility could reasonably be expected to hurt State and local governments by forcing reductions in services in the vital areas of health, education, environmental control and the very basic services that we all try to deliver.

Fifth, deductibility also helps narrow the unavoidable interstate and intrastate and regional tax differentials. Tax levels may vary in different parts of the country, between neighboring States and within States for a number of reasons that are very well-known.

Deductibility helps mitigate these differences. Conversely, eliminating deductibility would sharply increase the cost of needed government services in the higher tax areas, creating an incentive for the more affluent taxpayers in these areas to move to an area where lower tax incidence occurred. The less well off, the elderly, the poor, would, as usual, not have such an option to relocate. This would certainly aggravate the fiscal disparities with which you are all so familiar.

Sixth, deductibility also provides an incentive for State and local governments to use what has heretofore been considered better taxes, progressive taxes to raise revenue to finance their needed public services in lieu of less progressive taxes.

Eliminating deductibility would not only eliminate this incentive to use more progressive taxes, but it would also create new incentives to rely more on user fees and other regressive revenue sources, would increase and encourage the use of taxes on businesses which would retain their broad Federal deductibility, and would likely lead to more interstate competition in the business tax area.

In conclusion, the Federal deductibility of State and local government taxes has been a part of the Federal income tax because it provides a number of important benefits to the total intergovernmental revenue structure. As partners in providing government services, deductibility provides an important link between the Federal, State and local governments that helps assure that the State and local governments will be able to generate sufficient revenue to finance adequately those services that are best suited for those governments to provide.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much, Dr. Stettler.

[Dr. Stettler's prepared statement, on behalf of the National Association of State Budget Officers, follows:]

NATIONAL ASSOCIATION OF STATE BUDGET OFFICERS

HALL OF THE STATES 400 NORTH CAPITOL STREET, N.W. WASHINGTON, D.C. 20001 (202) 624-5382

Testimony

of

Dr. H. Louis Stettler, III
Secretary of the Maryland Department of
Budget and Fiscal Planning

on Behalf of

The National Association of State Budget Officers

Before The

United States House of Representatives
Committee on Banking, Finance and Urban Affairs
Subcommittee on Economic Stabilization

May 23, 1985

Good Morning. Mr. Chairman, I am Dr. H. Louis Stettler, III Secretary of the Department of Budget and Fiscal Planning for the State of Maryland and a member of the National Association of State Budget Officers (NASBO). As you are aware, NASBO is affiliated with the National Governors' Association and is the principal organization for the development of the Governors' national fiscal and executive management policies. I want to thank you on behalf of our association for providing this opportunity to contribute to your deliberations on the federal deductibility of state and local government taxes.

The deductibility of State and Local taxes from federal taxable income has been a part of the U.S. income tax since it was first enacted in 1913. In fact, deductibilty's history goes back even further to the Civil War when an emergency federal income tax was adopted and state and local taxes were deducted from taxable income. Over the years there have been very few changes to the state-local tax deductibility provisions in the U.S. income tax. In 1964, the deductions for state and local excise taxes, other than on gasoline, and for motor vehicle operators' license fees were eliminated and in 1978 the deduction for gasoline excise taxes was terminated. During the almost 75 years that the U.S. income tax has been in existence, however, the major state and local taxes assessed on individuals -- the individual income, sales and property taxes -- have always been deductable.

This long history of state and local tax deductibility does not by itself provide proof that it should be maintained, but there are several important reasons why it has been in existense for so long and why it should continue to be a major component of the federal income tax.

First of all, and probably most important, deductibility is an important link in the overall system of fiscal federalism. Secondly, it promotes tax fairness by preventing double taxation and by helping establish a federal taxable income level that is based on a person's ability to pay. Thirdly, deductibility is utilized by a broad group of taxpayers. Fourth, deductibility enhances state and local governments' ablility to generate revenues and, fifth, it helps reduce the impact of unavoidable intrastate and interstate tax differentials. Sixth, deductibility also provides an incentive for state and local governments to have more progressive tax structures.

For these reasons the National Association of State Budget Officers strongly opposes the elimination of the federal deductibility of state and local taxes.

Before I elaborate on these important points, I would like to make one very important point — state and local governments are not just another "special interest group". State, city, county, school districts and federal governments work together under the federal system to provide a responsible intergovernmental network that is responsive to the needs of the people. There is a big difference between providing food to needy children and the three-Martini lunch; between providing transportation to public schools and "business trips" to the Super Bowl. State and local governments are in the same business as the federal government, i.e., elected officials are trying to provide needed public services to the people in an efficient way. The relationship between state and local governments and the federal government is much broader and much more complicated then just the cost of deductibility and this must be addressed in this overall discussion.

Federalism

The fiscal federalism that has developed in the U.S. is basically designed to provide coordination between the different levels of government in regards to the services they each provide and the taxes and fees they use to finance these services. Under federalism, state, city, county and federal governments are partners in providing needed public goods and services. Without any link between these different levels of government, the competition for tax revenue would place state and local governments at a disadvantage compared to the federal government and would impede their efforts to provide certain public goods that are best provided at the state or local level. Deductibility has served as this important link in the intergovernmental system. Since the U.S. income tax was enacted the policy has been that income used to pay state, city, county and school district taxes would not be taxed again by the federal government. To reverse this policy would have severe consequences. State and local government's ability to balance their budgets would be made more difficult at the same time they are being asked to be the prime provider of domestic services.

Taxpayer Equity

Deductibility of state and local government taxes also adds fairness to the intergovernmental tax system by preventing double taxation, or a tax on another tax. Without deductibilty the federal income tax would be assessed on income that individuals have already paid to state and local governments in the form of income, sales and property taxes. This double taxation would increase the tax burden on individuals. This issue also relates to the principle that individuals should be taxed according to their ability to pay, a principle the federal income tax system has long adhered to. Since individuals can not avoid paying state and local income, sales and property taxes, deductibility of these items helps make the federal income tax more equitable by reflecting better a taxpayers ability to pay. Other federal income tax deductions, such as those allowed for medical expenses and uninsured casually losses, also unavoidable expenses, are also intended to better reflect a person's ability to pay the tax. Therefore, eliminating deductibility would be counter to the ability to pay principle and a step in the wrong direction since the final destination of these efforts should be a fair system of taxation.

Who Claims The State and Local Tax Deduction?

Another important point that deserves special emphasis is that deductibility is not a special tax break to the wealthy. According to the 1982 Statistics of Income for Individual Income Tax Returns, published by the Internal Revenues Service, 51 percent of all returns deducting state and local taxes were from people earning less than $30,000 and 87 percent were from people whose income was less than $50,000. Clearly the middle class taxpayer benefits greatly from the deduction of state and local taxes. In addition, more taxpayers claim the state and local tax deduction than the home mortgage interest deduction. In 1982, 33.1 million taxpayers claimed the state and local tax deduction, while 25 percent fewer taxpayers, 24.5 million, claimed the home mortgage interest deduction.

Impact on Prices of Services

One of the important ways that deductibility helps maintain a fiscal balance between the different levels of government is that it effectively lowers the relative prices of services provided by state and local governments. For example, a taxpayer with a state tax liability of $1,000 and a marginal federal income tax rate of 30 percent can use deductibility to reduce the net state tax liablity by $300 to $700. Therefore, this taxpayer's net state tax liability of $700 actually provides governmental services worth $1,000.

The removal of the deductibility of state and local government taxes would increase the net cost to the taxpayer of state and local taxes yet the amount of needed state and local services would not change. Going back to the example, the elimination of deductibility would raise the taxpayers state income tax to $1,000, but there would be no change in the amount of services provided, or in other words, the cost of state and local services would increase. Therefore, the loss of deductibility would definitely hurt state and local governments by forcing reductions in needed services. The degree to which state governments in the aggregate would be forced to cut spending has been estimated as much as 21 percent. In addition, the impact would definitely not be uniform between the individual states, but the exact impacts by state are not known. So while there is some debate on the magnitude of the impact, there is no argument on one point and that is state and local government spending would definitely be reduced if deductibility were eliminated. Even at the present time, with deductibility, the budgets of state and local governments are feeling pressures from the tax revolt movement, which is by no means dead. The loss of deductibility, which would be an estimated $35 billion in fiscal 1986, would certainly add momentum to tax reduction sentiment and state and local governments would definitely be adversely affected.

Narrowing Regional Tax Differences

Deductibility also helps narrow the unavoidable interstate, intrastate and regional tax differentials. Tax levels may vary in different parts of the country for a number of reasons. For instance, a state rich in a natural resource like oil can tax the oil and thus rely less on taxes assessed on individuals such as the income and sales taxes. On the other hand, an older industrial city whose economic base is deteriorating may need a higher level of taxes to meet growing social needs. Deductibility helps mitigate these regional differences. Conversely, eliminating deductibility would sharply increase the cost of needed government services in the higher tax area, creating an incentive for the more affluent taxpayers in the higher tax area to move to an area with a low tax incidence on individuals. The less well off, the elderly and the poor would not have the option to relocate. Without deductibility the economic base of higher tax areas would likely be adversely affected and therefore the problems that already existed would only be exacerbated. This is an important point that bears repeating -- the problems that create tax differentials, whether poverty or some other social factor, would not go away if dedudibility was eliminated. These problems would still need to be addressed and as already discussed, state and local governments would be less able to do this. With deductibility not only do those taxpayers benefit who claim the deduction, but the people who need the government services also benefit.

More Progessive State and Local Taxes

Deductibility also provides an incentive to state and local governments to use more progressive taxes to raise the revenue to finance needed public services. The more progressive the tax, the more the burden of the tax will fall on those people most likely to itemize deductions and therefore the lower the effective price of the services provided by the state or local government.

Eliminating deductibility would not only eliminate this incentive to use more progressive taxes, but it would create new incentives to rely more on user fees and other regressive revenue sources and it would encourage the use of taxes on businesses. State and local taxes on business would still be deductible at the federal level, so there would definitely be an incentive to place more of the state-local tax burden on businessess, particular corporate businesses. The importance of this point should not be underestimated.

Conclusion

In conclusion, the federal deductibility of state and local government taxes has been a part of the federal income tax because it provides a number of important benefits to the total intergovernmental revenue structure. As partners in providing government services, deductibility provides an important link between the federal, state and local governments that helps assure that state and local governments will be able to generate sufficient revenue to adequately finance those services they are best suited to provide. Eliminating deductibility would inhibit state and local governments ability to generate the revenues needed to supply the level of services they currently provide. In fact, the removal of deductibility would in effect cause the price of state and local government services to increase and this would undoubtedly lead to reductions in needed state and local services. Deductibility also helps mitigate tax level differentials within states, between states and between regions of the country. Without deductibility these differences would only become worse and as a result the problems of the higher tax areas would grow. In addition, deductibility improves the equity of the federal income tax by preventing the double taxation of the income used to pay state and local taxes. This improves the fairness of the federal income tax because it results in a better measure of a person's ability to pay the tax. Deductibility also provides an incentive to states to develop more progressive tax structures.

In brief, eliminating deductibility would alter the current federal system in a way that would force state and local governments to reduce services at the very time we are being directed to accept additional responsibilities to fund needed services that have been removed from the priority list of the Federal government. States would also be forced to turn to more regressive taxes and/or to increase the tax burden on businesses. In addition, eliminating deductibilty would reduce the tax equity of the federal income tax. For these reasons, NASBO is strongly opposed to eliminating deductibility and strongly believes that its elimination is the most severe current threat to the values and intent of our federalist system as it would weaken thee capability of states to provide the services demanded by the people.

Chairman **LaFalce**. We will now hear from Ms. Linda Tarr-Whelan, the director of government relations for the National Education Association. Ms. Tarr-Whelan.

STATEMENT OF LINDA TARR-WHELAN, DIRECTOR, GOVERNMENT RELATIONS, THE NATIONAL EDUCATION ASSOCIATION

Ms. **Tarr-Whelan**. I particularly congratulate the chairman and this committee for dealing with this issue in terms of the question of economic stabilization because it is our belief that ending the deductibility of State and local taxes would clearly destabilize the longstanding patterns of education funding and raise new obstacles to educational excellence. We believe that on several bases. First, let me discuss for a moment the funding of education today, and you will see why this particular proposal would undermine all the parts of educational funding.

Education is in fact a partnership between the Federal, State, and local government areas. A total of approximately $125 billion is spent every year on elementary and secondary education. That money, which comes from all three levels of government, would be affected by the issue of ending deductibility.

The direct Federal Government share of public school funding is approximately 6.2 percent. The States provide 49 percent of public schools' cost, and local governments provide 44.8 percent of public school support.

The average figures are there, as I mentioned, but it does vary a great deal from State to State. For example, the Federal Government share ranges from 3.2 percent to more than 17 percent, and the State and/or local share averages from 8 percent to 91 percent.

I have included a number of tables for the committee on how this goes State by State, and also some very important trends as we see the States picking up a larger and larger share of school costs over the last 12 years, and local governments picking up a smaller share.

The National Conference of State Legislatures has just recently released a study showing that 23 of the States have raised education funding more than 10 percent in the last 2 years, so that we have the State and local governments paying more than the lion's share of education. They would be really dramatically affected by a change in the Federal tax structure that affected their ability to raise revenues from their citizens.

Right now, about 36 percent of all State and local expenditures is for the area of education. And that really does vary from State to State, from about 18 percent to 47 percent. But it is one of the areas, particularly in terms of local school bonds and school referenda, where the voters vote directly on their tax rate for a particular service. We find that, as we look at the States, approximately 4 percent of personal income is devoted to funding public education, again with the range from about 2.8 percent to 7.5 percent.

In the last 5 years, the total expenditures for education have risen from $102 billion to the current $125 billion, without any real Federal assistance whatsoever. In fact, the Federal Government's share has not even kept pace with inflation. And those figures show that the States and local governments are in fact carrying out the larger responsibility with regard to education in this country.

In fact, it's important for this committee, looking at the deductibility issue, to realize that the Federal Government has in fact moved back from its appropriate role of funding education programs. We have had direct budget cuts and losses due to inflation in such programs as chapter I for disadvantaged youngsters, which must now be picked up by State and local government. We now are serving about 45 percent of the estimated 11 million youngsters who need the program; a few years ago, we used to serve 55 percent.

I raised the issue about how the Federal Government funding for education is affected because I believe a change in deductibility would place the Federal Government in a position of causing double jeopardy to the schools.

First of all, the direct funds have been cut; and, second, the base for raising school revenues at the State and local level would be undermined.

It is interesting to us that the Treasury Department proposal, which would yield an estimated $39 billion, is just about exactly the amount by which individual income taxes were reduced in the first year of the 1981 Economic Recovery Act, the average taxpayer saving approximately $400.

I'd like to just speak for a moment on the impact of the Treasury proposal on public education. We have used a very conservative estimate in our testimony, that of the Advisory Commission on Intergovernmental Relations, which notes that there would be a decline of 7 percent in State and local expenditures. I believe this committee is also familiar with the work done by the Congressional Research Service, which talks in terms of a 15-percent impact, and notes that deductibility is fully 25 percent of all of the Federal assistance to the State and local government level.

Using a conservative estimate, a 7-percent reduction in funding would be $4.8 billion or approximately $122 per child enrolled. A 7-percent reduction would, in effect, repeal chapter I and the Education for all Handicapped Children Act—in other words, the funding which goes into those two proposals. Or, placed another way, the loss of $4.8 billion would reduce national per pupil expenditures from $3,429 to $3,317, canceling out almost a full year of program improvements in education.

Last, let me state that we believe the school revenue base would be threatened by this measure, that it would in fact dampen the strong efforts that many States are making to enhance the quality of education.

We are finding in recent years a greater acceptability at the State and local level of paying for improvements in education, and a recognition that this is in fact an investment of great importance.

There is a chart attached to our prepared statement which we call to your attention. State and local taxes have a greater level of acceptability now than they have in many years; in fact, we are seeing a very strong support for that level of taxation. And that would in fact be undermined and the public acceptance of paying for the services in education would be undermined by losing the Federal tax deductibility.

Therefore, Mr. Chairman, we would like to reiterate just a few points from our testimony. We believe the deductibility of State and local taxes is a strong incentive to the States to maintain and increase their support for education. Education is the largest single item in most State budgets and if we change this particular funding mechanism through deductibility, we would undermine public acceptance of State and local revenue mechanisms that support education.

At a time when the Federal Government has reduced its direct appropriations for education, loss of the indirect support through deductibility would cause a very unfair and injudicious burden on education.

We thank the subcommittee for its consideration of this matter and the opportunity to testify today.

Chairman **LaFalce**. Thank you very much.

[Ms. Tarr-Whelan's prepared statement on behalf of the National Education Association follows:]

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LEGISLATIVE INFORMATION

STATEMENT OF

THE NATIONAL EDUCATION ASSOCIATION

ON THE

DEDUCTIBILITY OF STATE AND LOCAL TAXES

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 23, 1985

MARY HATWOOD FUTRELL, President ● KEITH GEIGER, Vice-President ● ROXANNE E. BRADSHAW, Secretary-Treasurer
DON CAMERON, Executive Director [illegible]

Mr. Chairman and Members of the Subcommittee:

I am Linda Tarr-Whelan, director of Government Relations for the National Education Association, representing 1.7 million education personnel in the nation's schools and institutions of higher education. It is our understanding that the Treasury Department's proposed tax reform package includes the elimination of deductibility for taxes paid to state and local governments. We have grave concerns about this proposal, which would clearly destabilize longstanding patterns of education funding and raise new obstacles to educational excellence.

Education is a critical element in our country's quest for a knowledgeable citizenry, an expanding economy, and a strong and secure nation. Now is the time we should be seeking new resources to enhance the quality of our schools, not playing with plans that would reduce financial support for public education. The stakes are very clear: the vibrancy of our economy, our place in the international community, the lives and opportunities of millions of young men and women. To undermine support for education is to jeopardize America's future.

We appreciate the attention which this Subcommittee is giving to the likely effects of the Treasury proposal on our nation's economic growth and security. Your leadership is to be commended.

The Education Partnership

Since the passage of the Northwest Ordinance in 1785, the federal government has provided crucial leadership and financial support to education as a critical national concern. At the present time expenditures for public elementary and secondary education amount to $125 billion per year.

* The direct federal government share of public school funding is 6.2 percent.

* The states provide 49 percent of public school costs.

* Local governments provide 44.8 percent of public school support.

These are average figures; the range of federal funding in the states is from 3.2 percent to more than 17 percent. The state share, in foundation programs and other forms of support, ranges from eight percent to 91 percent. Local contributions range from 0.3 percent to 89 percent. These funding patterns vary according to state laws governing the application of the revenue base to school financing. For the Subcommittee's information, we have included a breakdown of school funding by dollars and percentages, state by state, in Table I in the appendix to this statement. Table II shows the trends of state and local revenues for public schools over the past 12 years. During that time, the state share of education expenditures has increased from 40 percent to nearly half, while the local share has declined from 52 percent to 44 percent. This is due to changes in state law, including limitations on the local property tax.

States are Paying Their Share

The states have clearly extended themselves to provide quality education, both in terms of per capita expenditures and as a percent of expenditures for all functions. An estimated 36 percent of all state and local expenditures is earmarked for education. Education is the single largest expenditure by state and local governments and it is usually the only one on which taxpayers vote directly. The range of state-by-state percentages is from 18 percent to 47 percent, as shown in Table III.

On the average, four percent of personal income in the states is devoted to funding public education, with a range from 2.8 percent to 7.5

percent. The actual yield of this tax effort is in average per pupil expenditures which range from $1900 to $6400, and average teacher salaries which range from $14,000 to $34,000. State-by-state comparisons of tax effort and per pupil expenditures are shown in Table IV.

In the last five years, total expenditures from education have risen from $102 billion to the current $125 billion. This growth of expenditures is a good measure of state commitment to education, because during that same period enrollments in the public schools dropped from 41 million pupils to 39.3 million. A substantial part of the increase in state and local support is due to efforts to reduce class size, improve teacher training, and provide better instructional materials. The proposal to eliminate the deductibility of state and local taxes would be a serious disincentive in states which are exerting massive effort to improve the quality of instruction.

Federal Role Diminished

The President of the United States makes much of the public interest in improving the nation's schools. And yet his budget and tax proposals have consistently worked to the detriment of education. Our national campaign for excellence has been subverted by budgets that diminish federal support for education; by the reduction of federal funding for other state-operated social and welfare programs; by the lapse of revenue sharing; and by tax reductions for the wealthy and corporations that place increasingly heavy loads on state and local governments.

The fact that federal appropriations have been undercut by inflation losses and outright budget cuts has severely limited the outreach of school programs such as Chapter 1 for the disadvantaged, education of the handicapped, vocational and adult education, and student assistance. Fewer students are being served than in 1981.

- More than half a million students have found themselves ineligible for Pell Grants and other forms of federal aid.

- We used to serve 55 percent of pupils eligible for Chapter 1 programs for the disadvantaged, but now we are able to serve only 45 percent of the estimated 11 million who need the services of this program.

Because of budget cuts, local school districts are simply unable to deliver the full benefits of programs that Congress established for the purpose of advancing educational and economic opportunity. The current appropriations for programs administered by the Education Department is $17.9 billion, but more than $21 billion is needed to provide services comparable to those offered in 1980. The actual losses to inflation since 1980 for major programs are shown in Table V in the appendix.

Deductibility and Tax Fairness

Since 1913, taxes paid by individuals to state and local governments have been deductible from gross income. This provision has remained in the statute primarily because it helps to relate taxable income to the individual's ability to pay. In this sense it is a key element in a tax system based on the principle of progressivity. It is this principle of progressivity -- and basic fairness -- that generates a degree of public acceptance and cooperation that is almost unheard of in other major industrialized nations.

The Treasury proposal is a tax increase that would yield an estimated $39 billion - which happens to be exactly the amount by which individual income taxes were reduced in the first year of the 1981 Economic Recovery Tax Act. According to the Advisory Commission on Intergovernmental

Relations, the average taxpayer saved $410 in federal taxation in 1980 as a result of the deductibility of state and local taxes. State and local governments find revenue raising easier because there is greater acceptance due to the lessening of the federal tax burden. The state-by-state savings to taxpayers from the deductibility provision are shown in Table VI.

An Indirect and Badly Needed Federal Subsidy for Education

Deductibility of state and local taxes is also an indirect but extremely powerful federal subsidy to state and local governments. It is a tax-efficient approach to school funding; an estimated $16.5 billion of the deductions for state and local taxes are used for education. Because education is increasingly a matter of national priority, it makes good sense to continue the indirect federal subsidy that the deductibility pass-through represents.

Impact of the Treasury Proposal on Public Education

What would happen to school financing if Congress were to deal another blow by repealing the deductibility of state and local taxes? The Advisory Commission on Intergovernmental Relations estimates that there would be a decline of seven percent in state and local expenditures. We believe this to be a conservative estimate.

* A seven percent reduction would be $4.8 billion, or $122 per child enrolled.

* A seven percent reduction in state funding would, in effect, repeal Chapter 1, and the Education for All Handicapped Children Act!

* Stated another way, the loss of $4.8 billion would reduce national per pupil expenditures from $3429 to $3317, cancelling out almost a full year of program improvement in education.

The Congressional Research Service estimates an even greater impact - that state and local services would be cut by as much as 15 percent. CRS also notes that deductibility of state and local taxes represents fully 25 percent of all federal assistance.

There is substantial competition for tax dollars at the state level, and a side effect of a reduction in education funding could well be a decline in all state services. Because education, health, and welfare programs are closely interrelated at the state and local levels, the cumulative effect of adopting the Treasury proposal could be the crippling of many services that bring security and stability to millions of individuals and families.

School Revenue Base Threatened

Most states have constitutional requirements that their budgets be balanced. The change proposed by the Treasury Department cannot but compound the difficulty of passing adequate appropriations for school support at the state level. This could seriously dampen the strong efforts many states are making to enchance the quality of education.

The local property tax is still a major factor in school finance, and the deductibility of property taxes paid would also be eliminated by the Treasury proposal. It makes no sense at all to tamper with a revenue source that is increasingly viable. We call your attention to an ACIR study, "Changing Attitudes on Government and Taxes," which shows that 35 percent of the population believes the federal income tax is the least fair, while only 26 percent object to the local property tax on the same grounds. This represents a major change over the past decade. In 1972, only 19 percent thought the federal income tax was the least fair, and 45 percent felt that way about the local property tax. The opinion trends are shown year by year in Table VII.

Conclusion

Mr. Chairman, the NEA Representative Assembly of 7000 delegates has spoken out on issues of tax equity in the following statement from the NEA Legislative Program for the 99th Congress:

> "NEA supports a progressive tax system based on individual and corporate ability to pay to yield sufficient revenues to address national needs; equity in taxation rates between married and single taxpayers; and repeal of tax indexing.
>
> "NEA opposes unfair tax loopholes or giveaways which reduce federal revenues; and any constitutional amendment respecting tax limitations or the federal budget."

The deductibility of state and local taxes is a strong incentive to the states to maintain and increase their support of education. Education is the largest single item in most state budgets, and the Treasury proposal would seriously undermine public acceptance of the state and local revenue mechanisms that support education. It would weaken the strong leadership role states have taken in pursuit of excellence. When combined with reduced direct federal appropriations for education, repealing the deductibility of state and local taxes would be a crippling blow to education. We ask your support for retaining the deductibility in current law.

APPENDIX

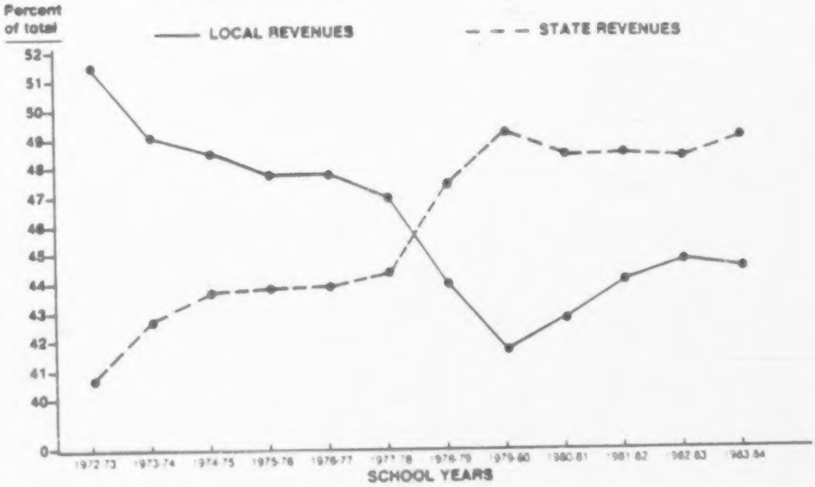
Table I. Funding Patterns for Public Schools

REGION AND STATE	REVENUE RECEIPTS BY SOURCE (IN THOUSANDS) FEDERAL	STATE	LOCAL AND OTHER	TOTAL	PERCENT OF REVENUE RECEIPTS BY SOURCE FEDERAL	STATE	LOCAL AND OTHER	NONREVENUE RECEIPTS (IN THOUSANDS)	TOTAL RECEIPTS (COLS. 5 AND 9) (IN THOUSANDS)
1	2	3	4	5	6	7	8	9	10
50 STATES AND D.C.	$8,585,605	$67,388,982	$61,598,030	$137,572,617	6.2	49.0	44.8	$3,992,297	$141,564,914
NEW ENGLAND	401,064	2,966,617	4,153,083	7,520,764	5.3	39.4	55.2	29,064	7,549,828
CONNECTICUT	105,720	851,178	1,173,215	2,130,113	5.0	40.0	55.1	400	2,130,513
MAINE	47,525	318,583	258,632	624,740	7.6	51.0	41.4	15,000	639,740
MASSACHUSETTS	190,510	1,459,831	1,782,894	3,433,235	5.5	42.5	51.9	6,000	3,439,235
NEW HAMPSHIRE	15,647	39,567	437,986	493,200	3.2	8.0	88.8	1,364	494,564
RHODE ISLAND	20,741	184,196	295,356	500,293	4.1	36.8	59.0	0	500,293
VERMONT	20,921	113,262	205,000	339,183	6.2	33.4	60.4	6,300	345,483
MIDEAST	1,144,409	12,175,271	15,291,950	28,611,630	4.0	42.6	53.4	1,236,426	29,848,056
DELAWARE	30,800	272,660	89,200	392,660	7.8	69.4	22.7	10,600	403,260
DIST. OF COLUMBIA	43,529	...	340,652	384,181	11.3		88.7	...	384,181
MARYLAND	152,223	1,084,361	1,446,420	2,683,004	5.7	40.4	53.9	3,561	2,686,565
NEW JERSEY	194,600	2,288,900	3,238,900	5,722,400	3.4	40.0	56.6	87,100	5,809,500
NEW YORK	501,417	5,422,000	6,659,908	12,583,325	4.0	43.1	52.9	566,675	13,150,000
PENNSYLVANIA	221,840	3,107,350	3,516,870	6,846,060	3.2	45.4	51.4	568,490	7,414,550
SOUTHEAST	2,489,784	15,175,380	9,354,247	27,019,411	9.2	56.2	34.6	743,159	27,762,570
ALABAMA	195,000	1,182,119	255,000	1,632,119	11.9	72.4	15.6	80,000	1,712,119
ARKANSAS	117,533	634,853	320,000	1,072,386	11.0	59.2	29.8	7,808	1,080,194
FLORIDA	412,572	3,061,069	2,251,450	5,725,091	7.2	53.5	39.3	78,000	5,803,091
GEORGIA	269,265	1,430,151	1,144,580	2,843,996	9.5	50.3	40.2	51,869	2,895,865
KENTUCKY	171,000	1,160,500	359,000	1,690,500	10.1	68.6	21.2	75,000	1,765,500
LOUISIANA	226,300	1,254,300	866,600	2,347,200	9.6	53.4	36.9	78,000	2,425,200
MISSISSIPPI	182,015	578,926	260,126	1,021,067	17.8	56.7	25.5	27,682	1,048,749
NORTH CAROLINA ...	288,100	1,713,600	786,200	2,787,900	10.3	61.5	28.2	10,500	2,798,400
SOUTH CAROLINA ...	120,633	1,095,365	527,740	1,743,738	6.9	62.8	30.3	120,000	1,863,738
TENNESSEE	193,310	976,177	788,700	1,958,187	9.9	49.9	40.3	132,500	2,090,687
VIRGINIA	210,542	1,364,763	1,484,673	3,059,978	6.9	44.6	48.5	80,000	3,139,978
WEST VIRGINIA	103,514	723,557	310,178	1,137,249	9.1	63.6	27.3	1,800	1,139,049
GREAT LAKES	1,231,771	9,736,556	13,372,164	24,340,491	5.1	40.0	54.9	712,915	25,053,406
ILLINOIS	441,192	2,488,443	3,684,668	6,614,303	6.7	37.6	55.7	156,731	6,771,034
INDIANA	120,000	1,524,000	1,211,000	2,855,000	4.2	53.4	42.4	73,500	2,928,500
MICHIGAN	254,048	2,034,386	3,721,310	6,009,744	4.2	33.9	61.9	57,000	6,066,744
OHIO	310,000	2,600,000	3,190,000	6,100,000	5.1	42.6	52.3	400,000	6,500,000
WISCONSIN	106,531	1,089,727	1,565,186	2,761,444	3.9	39.5	56.7	25,684	2,787,128
PLAINS	520,137	4,147,526	5,005,624	9,673,287	5.4	42.9	51.7	171,313	9,844,600
IOWA	92,069	708,265	886,982	1,687,316	5.5	42.0	52.6	35,775	1,723,091
KANSAS	68,900	681,319	761,478	1,511,697	4.6	45.1	50.4	24,546	1,536,243
MINNESOTA	106,000	1,347,100	1,140,220	2,593,320	4.1	51.9	44.0	43,000	2,636,320
MISSOURI	144,668	871,342	1,323,444	2,339,454	6.2	37.2	56.6	45,192	2,384,646
NEBRASKA	45,000	232,000	548,000	825,000	5.5	28.1	66.4	15,000	840,000
NORTH DAKOTA	25,000	209,500	117,500	352,000	7.1	59.5	33.4	7,000	359,000
SOUTH DAKOTA	38,500	98,000	228,000	364,500	10.6	26.9	62.6	800	365,300
SOUTHWEST	1,217,222	7,435,031	6,118,698	14,770,951	8.2	50.3	41.4	777,423	15,548,374
ARIZONA	160,000	801,000	568,000	1,529,000	10.5	52.4	37.1	0	1,529,000
NEW MEXICO	98,637	691,250	103,288	893,175	11.0	77.4	11.6	17,380	910,555
OKLAHOMA	146,000	1,220,000	620,000	1,986,000	7.4	61.4	31.2	110,000	2,096,000
TEXAS	812,585	4,722,781	4,827,410	10,362,776	7.8	45.6	46.6	650,043	11,012,819
ROCKY MOUNTAINS	245,900	2,136,886	2,368,379	4,751,165	5.2	45.0	49.8	176,906	4,928,071
COLORADO	80,000	819,594	1,139,262	2,038,856	3.9	40.2	55.9	45,000	2,083,856
IDAHO	34,000	325,000	143,000	502,000	6.8	64.7	28.5	10,000	512,000
MONTANA	55,500	276,973	283,217	615,690	9.0	45.0	46.0	19,710	635,400
UTAH	54,400	545,319	402,900	1,002,619	5.4	54.4	40.2	52,196	1,054,815
WYOMING	22,000	170,000	400,000	592,000	3.7	28.7	67.6	50,000	642,000
FAR WEST	1,335,318	13,615,715	5,933,885	20,884,918	6.4	65.2	28.4	145,091	21,030,009
ALASKA	20,149	501,748	161,518	683,415	2.9	73.4	23.6	23,527	706,942
CALIFORNIA	1,011,350	9,937,825	3,866,000	14,815,175	6.8	67.1	26.1	70,000	14,885,175
HAWAII	51,600	527,000	1,500	580,100	8.9	90.8	.3	0	580,100
NEVADA	18,400	182,000	260,000	460,400	4.0	39.5	56.5	8,400	468,800
OREGON	84,337	499,180	1,136,483	1,720,000	4.9	29.0	66.1	3,000	1,723,000
WASHINGTON	149,482	1,967,962	508,384	2,625,828	5.7	74.9	19.4	40,164	2,665,992

Souce: Estimates of School Statistics, 1984-85
NEA Research

Table II. State and Local School Revenues, 1972-1984

State and Local Revenue Receipts for Public Schools 1972-73 to 1983-84



Source: Property Taxation
NEA Research, 1985

Table III. State Education Expenditures as a Percent of All Expenditures

H-3. STATE AND LOCAL GOVERNMENT EXPENDITURES FOR ALL EDUCATION AS PERCENT OF TOTAL GENERAL EXPENDITURES FOR ALL FUNCTIONS, 1981-82

1.	UTAH	47.49
2.	INDIANA	44.12
3.	SOUTH CAROLINA	44.10
4.	NORTH CAROLINA	43.28
5.	OKLAHOMA	42.11
6.	ARIZONA	41.99
7.	TEXAS	41.56
8.	COLORADO	41.37
9.	NEW MEXICO	40.86
10.	NEBRASKA	40.58
11.	ARKANSAS	40.32
12.	MONTANA	40.31
13.	IOWA	40.16
14.	ALABAMA	39.86
15.	IDAHO	39.67
16.	WISCONSIN	39.06
17.	VERMONT	39.00
18.	WASHINGTON	38.94
19.	VIRGINIA	38.80
20.	KANSAS	38.70
21.	NORTH DAKOTA	38.54
22.	WYOMING	38.48
23.	MISSOURI	37.54
24.	MICHIGAN	37.50
25.	OREGON	37.40
26.	WEST VIRGINIA	36.96
27.	OHIO	36.45
28.	DELAWARE	36.29
29.	MISSISSIPPI	36.11
30.	SOUTH DAKOTA	35.81
	UNITED STATES	35.65
31.	KENTUCKY	35.63
32.	MARYLAND	35.44
33.	NEW HAMPSHIRE	35.18
34.	NEW JERSEY	35.04
35.	MAINE	34.76
36.	TENNESSEE	34.71
37.	ILLINOIS	34.64
	FLORIDA	34.64
39.	LOUISIANA	34.23
40.	MINNESOTA	34.18
41.	CONNECTICUT	34.15
42.	PENNSYLVANIA	33.73
43.	CALIFORNIA	33.72
44.	RHODE ISLAND	32.83
45.	GEORGIA	32.74
46.	NEVADA	30.70
47.	MASSACHUSETTS	29.18
48.	NEW YORK	28.98
49.	HAWAII	28.59
50.	ALASKA	25.24
51.	DIST. OF COL.	18.13

Computed from Bureau of the Census, *Governmental Finances in 1981-82*, pp. 15-31

Source: Rankings of the States, 1984
NEA Research

Table IV. State Tax Effort, Per Pupil Expenditures, Teacher Salaries

F-4. STATE AND LOCAL REVENUE RECEIPTS FOR PUBLIC SCHOOLS IN 1981-82 AS PERCENT OF PERSONAL INCOME IN 1982

1.	ALASKA	7.57
2.	WYOMING	6.88
3.	MONTANA	5.96
4.	UTAH	5.48
5.	NEW MEXICO	5.46
6.	MICHIGAN	5.10
7.	OREGON	5.09
8.	VERMONT	5.00
9.	WEST VIRGINIA	4.96
10.	MINNESOTA	4.79
11.	NEW YORK	4.62
12.	IOWA	4.60
13.	MAINE	4.57
14.	INDIANA	4.55
15.	NEW JERSEY	4.52
16.	IDAHO	4.51
	WISCONSIN	4.51
18.	SOUTH DAKOTA	4.33
19.	PENNSYLVANIA	4.32
20.	KANSAS	4.29
21.	ARIZONA	4.28
22.	OKLAHOMA	4.27
23.	DELAWARE	4.23
24.	MASSACHUSETTS	4.19
25.	WASHINGTON	4.18
26.	NORTH DAKOTA	4.17
27.	COLORADO	4.14
28.	TEXAS	4.12
29.	MARYLAND	4.11
	UNITED STATES	4.10
30.	RHODE ISLAND	4.05
31.	LOUISIANA	4.04
32.	SOUTH CAROLINA	4.02
33.	NEW HAMPSHIRE	3.97
34.	GEORGIA	3.95
35.	ARKANSAS	3.84
	NORTH CAROLINA	3.84
37.	OHIO	3.83
38.	ILLINOIS	3.82
39.	NEBRASKA	3.78
40.	HAWAII	3.72
41.	VIRGINIA	3.69
42.	NEVADA	3.68
	CONNECTICUT	3.68
44.	KENTUCKY	3.65
45.	MISSOURI	3.60
46.	MISSISSIPPI	3.56
47.	TENNESSEE	3.48
	CALIFORNIA	3.48
49.	FLORIDA	3.38
50.	ALABAMA	2.79
	DIST. OF COL.	NA

Computed from Bureau of Economic Analysis, *Survey of Current Business*, August 1983, p. 50, and NEA Research, *Estimates* data bank.

H-9. ESTIMATED CURRENT EXPENDITURES FOR PUBLIC ELEMENTARY AND SECONDARY SCHOOLS PER PUPIL IN AVERAGE DAILY ATTENDANCE, 1982-83 (REVISED)

1.	ALASKA	$6,381
2.	NEW YORK	4,434
3.	NEW JERSEY	4,428
4.	DIST. OF COL.	4,083
5.	WYOMING	4,043
6.	CONNECTICUT	3,666
7.	OREGON	3,604
8.	DELAWARE	3,524
9.	MARYLAND	3,488
10.	MONTANA	3,442
11.	MASSACHUSETTS	3,406
12.	RHODE ISLAND	3,389
13.	PENNSYLVANIA	3,385
14.	WISCONSIN	3,380
15.	HAWAII	3,347
16.	MICHIGAN	3,178
17.	MINNESOTA	3,136
18.	VERMONT	3,102
19.	KANSAS	3,093
20.	IOWA	3,055
21.	ILLINOIS	3,018
22.	COLORADO	2,961
	UNITED STATES	2,960
23.	FLORIDA	2,923
24.	OKLAHOMA	2,902
25.	WASHINGTON	2,878
26.	NEW MEXICO	2,841
27.	NORTH DAKOTA	2,836
28.	TEXAS	2,820
29.	LOUISIANA	2,780
30.	VIRGINIA	2,737
31.	CALIFORNIA	2,735
32.	NEBRASKA	2,708
33.	NEVADA	2,698
34.	OHIO	2,696
35.	MAINE	2,624
36.	NEW HAMPSHIRE	2,561
37.	INDIANA	2,532
38.	ARIZONA	2,512
39.	SOUTH DAKOTA	2,472
40.	WEST VIRGINIA	2,465
41.	MISSOURI	2,396
42.	KENTUCKY	2,368
43.	NORTH CAROLINA	2,265
44.	GEORGIA	2,155
45.	IDAHO	2,106
46.	UTAH	2,080
	SOUTH CAROLINA	2,080
48.	TENNESSEE	2,061
49.	ALABAMA	2,019
50.	ARKANSAS	1,998
51.	MISSISSIPPI	1,895

Computed from NEA Research, *Estimates* data bank.

C-11. ESTIMATED AVERAGE SALARIES OF PUBLIC SCHOOL TEACHERS, 1982-83 (REVISED)

1.	ALASKA	$33,983
2.	MICHIGAN	25,712
3.	DIST. OF COL.	25,610
4.	NEW YORK	25,000
5.	HAWAII	24,796
6.	CALIFORNIA	24,035
7.	WYOMING	23,690
8.	WASHINGTON	23,488
9.	RHODE ISLAND	23,175
10.	MARYLAND	22,922
11.	MINNESOTA	22,876
12.	ILLINOIS	22,315
13.	NEVADA	22,070
14.	MASSACHUSETTS	21,941
15.	OREGON	21,746
16.	NEW JERSEY	21,536
17.	WISCONSIN	21,496
18.	COLORADO	21,470
19.	PENNSYLVANIA	21,178
20.	ARIZONA	21,119
21.	CONNECTICUT	20,731
	UNITED STATES	20,725
22.	DELAWARE	20,625
23.	NEW MEXICO	20,380
24.	INDIANA	20,123
25.	OHIO	20,004
26.	UTAH	19,859
27.	MONTANA	19,702
28.	TEXAS	19,550
29.	IOWA	19,257
30.	NORTH DAKOTA	18,774
31.	VIRGINIA	18,535
32.	LOUISIANA	18,420
33.	KENTUCKY	18,385
34.	FLORIDA	18,275
35.	OKLAHOMA	18,270
36.	KANSAS	18,231
37.	ALABAMA	17,850
38.	IDAHO	17,585
	NORTH CAROLINA	17,585
40.	MISSOURI	17,521
41.	GEORGIA	17,412
	NEBRASKA	17,412
43.	TENNESSEE	17,380
44.	WEST VIRGINIA	17,322
45.	NEW HAMPSHIRE	16,549
46.	SOUTH CAROLINA	16,523
47.	VERMONT	16,271
48.	MAINE	16,248
49.	SOUTH DAKOTA	15,595
50.	ARKANSAS	15,029
51.	MISSISSIPPI	14,320

NEA Research, *Estimates* data bank.

Source: Rankings of the States, 1984
NEA Research

Table V. Diminution of Federal Support of Education, 1980-1985

Reagan Budget FY86 vs. Inflation Adjustment

National Table
Appropriations, Thousands of Dollars

Program	Appropriations FY80 (School Year '80-'81)	FY86 Adjusted For Inflation (School Year '86-'87) Since 1980	Reagan Budget FY86 (School Year '86-'87)	Difference Reagan Budget FY86 vs. Inflation Adjustment
Education Department	14399100	21870264	15512700	-6357556
SELECTED FEDERAL EDUCATION PROGRAMS:				
ECIA Chapter I (ESEA Title I Basic Grants)	3221099	4892409	3646615	-1245794
State Block Grant (ECIA Chapter II)	803503	1220411	531909	-688502
Impact Aid (not forward funded)	825000	1253062	543000	-710062
Education for the Handicapped	1049025	1593326	1306100	-287226
Vocational Education	801461	1214171	738462	-475709
Adult Education	100000	151886	100000	-51886
Bilingual Education	171763	260885	142951	-117934
New Math and Science Bill	0	0	100000	100000
Pell Grants	2528000	3839686	2880000	-959686
Supplemental Educational Opportunity Grants	370000	561979	0	-561979
College Work Study	550000	835375	850000	14625

NOTE: Figures for FY86 Adjusted for Inflation represent amounts required to maintain FY 1980 funding levels after accounting for inflation. Inflation (CPIU) is measured for the period of a Federal Fiscal Year (October 1 through September 30). Inflation estimates for 1985 are derived from projections by Data Resources, Inc.

Source: Fiscal Planning Services, Inc.
Washington, DC

Table VI.

FEDERAL TAX SAVINGS FROM DEDUCTIBILITY PROVISION, PER TAXPAYER,[a] BY STATE, 1980

	(1) Deductibility of All State and Local Taxes	(2) Deductibility of Sales Taxes Only
Alabama	$273.64	$ 74.41
Alaska	326.92	42.24
Arizona	322.68	75.65
Arkansas	312.36	45.45
California	581.37	89.45
Colorado	400.23	69.35
Connecticut	526.39	96.70
Delaware	614.45	7.68
Washington, DC	916.74	75.47
Florida	226.91	58.76
Georgia	392.94	60.20
Hawaii	564.14	83.88
Idaho	345.98	40.59
Illinois	432.31	88.44
Indiana	271.83	58.89
Iowa	413.47	43.03
Kansas	378.73	54.00
Kentucky	371.21	57.94
Louisiana	192.01	82.38
Maine	439.04	56.22
Maryland	640.19	67.89
Massachusetts	656.90	47.62
Michigan	553.47	59.02
Minnesota	584.38	45.21
Mississippi	277.23	76.56
Missouri	342.54	66.21
Montana	315.96	3.26
Nebraska	445.44	60.42
Nevada	192.89	49.02
New Hampshire	348.78	7.49
New Jersey	569.05	66.05
New Mexico	295.62	73.80
New York	892.12	105.01
North Carolina	417.11	50.93
North Dakota	251.24	37.71
Ohio	346.53	51.70
Oklahoma	335.65	57.37
Oregon	461.75	2.16
Pennsylvania	445.33	58.74
Rhode Island	547.65	60.89
South Carolina	341.30	54.48
South Dakota	230.15	72.00
Tennessee	203.03	89.16
Texas	232.78	75.57
Utah	329.37	62.41
Vermont	521.44	33.16
Virginia	477.91	58.60
Washington	234.82	85.68
West Virginia	344.22	50.32
Wisconsin	573.05	49.95
Wyoming	161.71	73.46
U.S. Average[b]	$410.21	$ 59.07

[a] Number of taxpayers was calculated by adding number of single returns itemizing state-local taxes to twice the number of joint returns itemizing state-local taxes. In 1980, 31% of all returns itemized state-local taxes. 96% of the returns itemizing some state-local tax itemized sales tax deductions. (Internal Revenue Service, *Statistics of Income—1980, Individual Income Tax Returns*, Washington, DC: U.S. Government Printing Office, 1982, Publication 79 (9–82), pp. 36, 56.)

[b] U.S. total excludes Puerto Rico and citizens abroad.

SOURCE: ACIR staff computations using unpublished 1980 IRS Individual Income Tax Model file.

Table VII. Public Opinion on Taxation

Which Do You Think is the Worst Tax—That is, the Least Fair?

	May 1983	May 1982	Sept. 1981	May 1980	May 1979	May 1978	May 1977	May 1975	April 1974	May 1973	March 1972
Federal Income Tax	35	36	36	36	37	30	28	28	30	30	19
State Income Tax	11	11	9	10	8	11	11	11	10	10	13
State Sales Tax	13	14	14	19	15	18	17	23	20	20	13
Local Property Tax	26	30	33	25	27	32	33	29	28	31	45
Don't Know	15	9	9	10	13	10	11	10	14	11	11

SOURCE: *U.S. Advisory Commission on Intergovernmental Relations. 1983 Changing Attitudes on Governments and Taxes.* Washington, DC 20575.

Chairman LaFalce. Ms. Tarr-Whelan, let me ask you especially, because I'm especially concerned about the impact this proposal would have on education because of the fact that no other budget that I'm aware of is voted on directly by the electorate of the United States, other than the educational budgets in most school districts across America. So, a few questions.

First of all, what percentage of the school districts of America do vote on their budgets? There are a few who do not vote, but do you have any idea about that?

Ms. Tarr-Whelan. I asked for that statistic and it didn't arrive before I left. My memory is that it's all but about 10 to 15 percent of the school districts; but I'd be happy to provide you the exact figure.

Chairman LaFalce. Yes, please.

Do you have an idea of the percentage of pupils who live in districts where there is a direct vote on the budgets? You could gather that statistic?

Ms. Tarr-Whelan. I'll be glad to send it to you, Mr. Chairman.

Chairman LaFalce. I may be asking for information you don't have, but that's all right if you try to get it.

Do you have any idea what percentage of elections for school budgets, or votes on school budgets were defeated the first time around in the last year, or the last couple of years, et cetera?

Ms. Tarr-Whelan. We do have the data, and there are some interesting trends. About 5 years ago, we were seeing a large number of such measures defeated at the polls, whether it was the first time around, sometimes up to the second and third time that a referenda or a millage issue was on the ballot.

This last year, we have seen a much higher acceptance by the public, and very few of them turned down. And, again, I'll give you the exact figures.

Chairman LaFalce. Can you give me any idea of approximately what percentage of those that did pass passed narrowly? You know, 51 to 49 percent, 54 to 46 percent, or what-have-you, as opposed to an overwhelming passage?

Ms. Tarr-Whelan. I'm sorry, Chairman LaFalce, I don't believe those data are available. I have never seen such data.

Chairman LaFalce. All right. I'm wondering if we could extrapolate, if there is able to be the development of that data, what percentage of voters who voted "yes" might change their mind were they not able to deduct taxes, and whether this might not bring about a precipitous increase in the number of school budgets that were defeated. It's quite easy to go from 54 to 46 percent to 46 to 54 percent, you know, have a reversal, if you just get 10 percent of the people or less to change their vote based upon the inability to deduct.

Ms. Tarr-Whelan. I think we could probably see if there is some polling data available there. It might be important for the subcommittee to know that we in education, as we try to get these kinds of bond issues passed, are faced with a very interesting problem. That is that less than 30 percent of citizens have children in school. That is in public or private school, elementary, secondary, or a higher education. It's really a factor of the demographics of our society with smaller families started later, older people living longer.

And so we are already faced with trying to convince the general public, many of whom do not have children in schools themselves, of the importance of paying taxes at the local and State level to support the public school system.

This would add, obviously, another major burden into that effort which we are already working on.

Chairman LaFalce. I wonder if we have any data based upon polling, I would assume, as to the percentage of people who vote traditionally, who are itemizers, as opposed to using the short form? Do we have any characterization of the people who vote on school district budgets, on the basis of income, on the basis of long form, short form, et cetera?

Ms. Tarr-Whelan. I've not seen that, but I'll certainly look and see if—there may be data for certain areas that would be useful for the committee. We can certainly check. I have not seen the aggregate data.

Chairman LaFalce. I would think that the individual who votes would tend to be slightly more affluent, at least, than the citizenry at large. I would think that those who vote in school budgets might be especially more aware of what is going on and, therefore, more likely to be itemizers. So I think we would have a disproportionate number of individuals who vote, their being itemizers in comparison to the rest of the country, and more likely to be concerned, and therefore, have a great wrath displayed at the voting booth regarding the elimination of deductibility than would be displayed in other elections.

Ms. Tarr-Whelan. Intuitively, I believe you're right, Mr. Chairman. The number of people who vote in school board referenda is very small, a very small percentage of the electorate.

Chairman LaFalce. Sure.

Ms. Tarr-Whelan. And my guess would be that your supposition is correct. We will see if we can find some data, because I think that that's a very important point. I think it extends, however, beyond those people who deduct, because what I think you have is a sort of general movement by the public or could have, if we ended deductibility, that we just better cut back State taxes, and we better cut back local taxes, whether it has a personal involvement to them or not. It just sounds like we're going to have to pay more than we would before. And I think you get a general electorate move that was larger than simply those people who normally deduct on their Federal income tax.

Chairman LaFalce. Thank you very much.

Mr. Carper.

Mr. Carper. I just want to thank the members of our panel for testifying today.

I come from a State, Delaware, where the top marginal rate's been cut from about 19 percent to about 10 percent, a cut of almost half over the last 6 or 7 years. We have a vested interest. as did our Senator from New York who testified earlier, in really maintaining the status quo.

Having said that, I am just going to ask each of our panelists, if you will, you've made the argument for why there should be no change on the deductibility of State and local taxes, what then—I'd ask you to put on another hat, and that's to give me some arguments as to why it should be changed.

There is no one on this panel who is making that argument. I know each of you know this issue well enough to be able to make the argument. I am going to ask you to do it.

Chairman LAFALCE. That's assuming you could conceive of one. [Laughter.]

Ms. TARR-WHELAN. Well, I think the customary arguments that are made around the bottom-line question of how do we get increased revenue into the U.S. Treasury, and there are lots of variable ways to do that and obviously, the argument here is that it's $39 billion.

I would suggest, as I did in the testimony, that this revenue loss of $39 billion was created, or a need to replace $39 billion was created by the 1981 tax bill and that there are other ways to address it, but that's not your question. Your question is one that is best answered on the bottom line, that the Congress must look at every possible way to increase the revenues and should weigh carefully what the ultimate results of the various choices would be.

Mr. CARPER. Thank you.

Dr. STETTLER. I guess my view is very much the same, that, you know, what we're talking about here is—because it is so broadly based and hits so heavily on the middle class, it is a very valuable, monetarily speaking, deduction. And I think the issue is, this is an amount that allows the nominal marginal rates to be reduced.

Every State at some time or another, yours, ours, has been faced with the issue of how do you adjust your revenues? The traditional position in Maryland has been in the last 15 years, when there has been at the State level, when there has been a major revenue adjustment, for the most part, it has been borne on the side of the rate.

A couple years ago, I'm sure you noticed that Delaware's economic activity on the border of Maryland went up, because we raised our sales tax.

Mr. CARPER. We appreciate that.

Dr. STETTLER. I'm sure you do. [Laughter.]

The other argument that is made is that the simplicity, of course, you know, we're trying to get rid of everything. The system is so complex that everything has to go, but in fact, even the reform measure is not saying everything must go. And much of the complexity is not just in the form. The itemizers and people who do that are fairly sophisticated people and can fill the form in. But much of the—from our analysis on the taxes, much of the difficulty and the time that is spent, is in defining the items that go into income in the first place and all the rules for depreciation.

This is a relatively simple deduction. Most people have a W-2 form from their State government, their local government. Second, the IRS in its generosity provides us with a table of sales tax deductions. Most people have seen their property tax bill which is rendered once a year in most States. So it's a relatively simple item for people to put together and get that number. It is not complex.

So we do not think that removing deductibility provides a major simplification.

Mr. **Carper**. Mr. Griset?

Mr. **Griset**. While I'm here to make a case for maintained deductibility, I think we all understand that there's an extremely wide range of debate going on that makes this all literally a cosmic issue perhaps, relative to other issues. I would simply just offer one argument contrary to the thrust of our testimony, and that is, the deductibility does a better job of reaching middle- and high-income taxpayers than it does those who are not, and in that respect our research seems to indicate that 40 percent or less of the taxpayers in the country itemize and, therefore, are eligible for enjoying the deductibility feature.

I think I would highlight that as an issue of balance or as an argument perhaps for not eliminating deductibility, but finding some ways in which the benefits of deductibility could be extended to cover all taxpayers in some form or fashion. Clearly, our concern is that by the time all the tradeoffs go on, not only do the responsibilities come our way, but the burden of those responsibilities is not sufficiently funded that we can meet it, as all these divestitures of responsibility and burdens of tax revenue raising come our way.

Mr. **Carper**. OK. Thank you all.

Chairman **LaFalce**. Mr. Wortley.

Mr. **Wortley**. Thanks, Mr. Chairman.

Mr. Chairman, I think this is a very valuable hearing, and I wish there were more Members present to participate in it. When we think about the economic consequences to our individual communities and our States, as well as the quality of education, it is a very, very important subject.

Let me ask each of you if you could just be very brief in your response.

Is anybody out there unhappy with the existing deductibility items that exist in the Federal Tax Code? Are you all reasonably happy with what's there now?

I'll allude particularly to charitable deductions, because I think that may affect education more than some other facets.

Ms. **Tarr-Whelan**. We have 1.8 million members. They are very concerned about the issue of deductibility of State and local taxes, and to some degree about the charitable deductions. Particularly those members in higher education, are concerned about those two areas. They are certainly not unhappy with the provisions as they exist now. What they are unhappy about is various balloons floated which may affect these issues and others which they consider directly affecting their well-being, such as taxation of employee benefits, for example. But we had not heard any problems with what existed till we sort of started to stir the pot and talk about changing what was there.

Mr. **Wortley**. Dr. Stettler.

Dr. **Stettler**. We have had, over the past 5 years, many bills in our legislature concerning adjustments to the Maryland system. We piggyback on the Federal system, and there are many people who feel that there ought to be some changes to make our system, they generally say, fairer.

For the most part, these have not dealt with the individual deductions, except in certain cases of expanding them. Most of the problems that have been presented to our legislature and have come from our legislature, in terms of the types of things where the change should be made are not either schedules A and B. They're on the other schedules.

Mr. WORTLEY. Mr. Griset.

Mr. GRISET. Mr. Congressman, I think our point of view, from the urban viewpoint, is that there are some concerns about the operations of the Tax Code. We have made, as a matter of policy statement, a priority in our organization to look at the operations and effects of tax expenditure, part of the tax system.

We see a problem in the ability to manage those costs, those losses of revenue, and we're here and have research that we would like to offer to the committee that highlights some of these concerns.

One example is that we're finding across the land in our cities, a problem of homelessness and a problem of how do we house the poor of our country on the side of tax expenditures, the deductibility of interest. And studies that we've done show that tremendous benefits through the tax expenditure side come to high income taxpayers deducting for second or vacation homes.

We're concerned, frankly, that failure to manage tax expenditures is helping those who need the least amount of help and are not allowing public policy to be directed where the needs are greatest.

That would be a general comment as to the workings of our tax system.

And you have, of course, our particular comments on this particular issue which can be considered a tax expenditure item, but has such a direct, and we think, workable purpose, subject to management in this review process.

Mr. WORTLEY. The principal thrust for tax reform lies in the concern about the fairness of the existing program.

And just a hypothetical question, suppose we threw out the income tax and we imposed the national sales tax or value-added tax. How would that affect you in State and local government?

Mr. GRISET. I'd like to comment. We have no policy on that subject, and if you don't mind, I'd like to defer response to that question.

Mr. WORTLEY. Dr. Stettler?

Dr. STETTLER. If you threw out the income tax and went to a value-added tax, I think we'd all be in shock, but once we—you know, the States—the States have traditionally been in the sales tax business, and we have typically generated substantial amounts of our revenue from them.

I would suspect that what would happen, should you go to a national sales tax and truly get rid of the income tax, that the States would continue to stay in the income tax business. There would be some—or, unless it was made simple for us to piggyback on your value-added tax.

One of the things we are concerned about, many States have been most concerned about over the last two decades, is a way in which we can simplify tax administration.

We conform to the Federal definitions. Should you go one way, and we remain with our income taxes, we would, of course, need then to create a structure for administering those. A national value-added tax would, if, you know, we could not piggyback on it, simply increase the total cost of tax administration. However, if it had a provision for piggyback, I think what you would find is, is that States would follow your lead.

Mr. **Wortley**. Well, certainly, a national sales tax, if we went to it, would eliminate the fairness concern. It also would create additional capital formation, because it would encourage people to save and perhaps invest more.

Let me go to Ms. Tarr-Whelan.

What percentage of local and State taxes, out of that whole pot, actually are spent on education?

Ms. **Tarr-Whelan**. It varies from State to State. And I've included a table, Mr. Wortley, in the prepared statement, but it averages approximately 36 percent of all State and local revenues go to education.

Mr. **Wortley**. Thirty-six percent?

Ms. **Tarr-Whelan**. That's correct. It does vary from State to State, however.

Mr. **Wortley**. Yes. What about a State like New York?

Ms. **Tarr-Whelan**. Well, I have the data here. It would take me a second to take a look at it.

It's on table 3, attached to the prepared statement and it is 28.98 percent in the State of New York.

Mr. **Wortley**. Somebody just handed me another table here. In New York State it amounts to about $5,226 per pupil.

Ms. **Tarr-Whelan**. That's the per pupil expenditure; correct?

Mr. **Wortley**. Per pupil expenditure.

Ms. **Tarr-Whelan**. That's correct.

Mr. **Wortley**. Of course, we have to raise that. So that's taxes that have to be raised per pupil.

Ms. **Tarr-Whelan**. I understand that averages out to 28.98 percent of the total State and local tax revenues being used for education in New York State.

Mr. **Wortley**. If we were to abolish the State and local tax deduction, do you see a major flight of populations or student population, particularly, from the high tax States to the Sun Belt perhaps or elsewhere?

Ms. **Tarr-Whelan**. I'm not sure. I have never really felt that people moving from one part of the country to the other was an adequate way to take a look at economic development toward public school development.

Mr. **Wortley**. The question is, Will those people who were adversely impacted be able to afford to move?

Ms. **Tarr-Whelan**. Well, the heavy tax States are seeing, like the rest of the country, some increase in their student population. You may have seen, even in this morning's paper, the District of Columbia, which has had a declining school population for many, many years, is experiencing increases. That is true in the heavy tax States of the Northeast and the Midwest.

Those people don't seem to be moving to the Southwest. We're having expansion in the schools there, but what we're getting is a sort of mini-boomlet across the United States. And I believe that's something that we really have to plan for.

In terms of the question of national sales tax, you mentioned that that would remove the question of fairness. From our perspective, I think it removes the question of progressivity and causes a real question about whether it will be fair or not.

From the standpoint of falling so heavily, in terms of—depending, of course, on how the sales tax was written, but on the percentage of one's income that lower income and middle income families have to expend. So that I'm not sure it would solve the fairness question.

Mr. **Wortley**. No, I certainly am not advocating the sales tax. I just wanted to get your response on it. [Laughter.]

I thank you, Mr. Chairman.

Chairman **LaFalce**. "Wortley Advocates Sales Tax"—"Value-Added Tax." I can see that headline now. [Laughter.]

Mr. **Wortley**. You put me in enough trouble with the Catholic bishops a while ago, don't——

[Laughter.]

Chairman **LaFalce**. When I heard Ms. Tarr-Whelan talking about the fact that we might have a less progressive tax, are you aware of the speech that the President gave in Spain, in which he let the cat out of the bag. He said what we're trying to do in the United States is have a less progressive tax, which should have not come as a surprise to anyone. A flat tax, by definition, is the exact opposite of a progressive tax, and, therefore, it is. The flatter it is, the less progressive it is.

So it flies in the face of what we have been attempting to maintain from 1913 to the present.

I have two points. One of the points is more in the nature of a question.

I am always amazed by the creativity of man to overcome virtually all obstacles. Particularly when we try to close loopholes in the Tax Code, we traditionally find a means of circumventing that. I couldn't do it as a Congressman, but if I were a practicing attorney, the chances are I would be a public corporation, or if I were a doctor, I think I would probably be incorporated. Certainly all the property that I owned, my business, would be under the professional corporation, and therefore, any taxes I paid would be deductible.

But I could easily, it would seem to me, if I were a professional corporation, transfer the ownership from me, as a person, to the corporation of a home, of the apartment, the condo that I had in Florida, whatever it might be, I don't have any such one—but all taxes that were paid by professionals could easily, with the existence of a simple form, be made deductible. It would be very difficult for the IRS to do anything about that, legally, if it wanted to. They might need separate legislation to prohibit that.

Any of you share the thought that that's possible? And if it is legally possible, it would seem to me, it would only be the most affluent in American society who do itemize, who could take advantage of that, because only they would be able to be professionals.

Ms. **Tarr-Whelan**. Mr. LaFalce, there certainly are some very clever tax lawyers, and I could see the scenario that you lay out as being, indeed, possible for a number of high-income taxpayers. I would just kind of add a postscript, in terms of the ability of professionals to do that. Professional schoolteachers would not be able to do that. We are not——

Chairman LAFALCE. They're not a professional corporation. You could easily form a corporation if you were a teacher, unrelated to your professional status and the corporation might be able to own that home because the preservation of the deductibility of State and local taxes for businesses remains. It's only individuals, and we in the United States have the option of owning things either individually or in a corporate nature. That's something that has been permitted to us—unless the Treasury wants to embark upon the path of eliminating the deductibility of State and local taxes for businesses also.

Ms. TARR-WHELAN. And that'll be interesting to watch in their proposal; yes.

Chairman LAFALCE. That would be very interesting, but we're going to have to conclude the hearing due to an upcoming vote. Some people have talked about economic ramifications. They're extremely important, no question about it. There is no question, they are more important for the higher tax States than for the lower tax States.

Some individuals have talked about compromises that could be developed. A man can in his ingenuity devise compromises, but I don't know that those are even the most important things. I really think we have to emphasize the fundamental principles of federalism that are at stake here.

We have to go back, we have to understand that what happened is we had a bunch of colonies that got together. Initially, they formed an Articles of Confederation, and then we went from the Articles of Confederation to the Constitution. But we developed a system of dual sovereignity. I know of no other government in the world that has such a system of dual sovereignity. In this system of dual sovereignity, the States were very jealous of their rights and their prerogatives, and before they agreed to a compact so that we could have a Federal union, they said there are certain things that should be left to the States and certain things that the Federal Government ought not to be able to do.

One of the things was there shouldn't be an ability for you to tax us or for us to tax you. That's point No. 1.

And second, since our citizenry will exist as dual citizens, we have to be careful when we tax these dual citizens. We're the first level of government.

Every single Federal Government and every single Congress and every single President has honored that right of the State and local governments to tax first.

And then they said we've got to determine, since we have to tax too, being the Federal Government, what it is we tax. We have to determine what our base will be for taxation. Suppose an individual makes $40,000. Well, how much of that $40,000 should we tax? What shall the base be? We'll look, first and foremost, to how much he pays in State and local taxes. And if he pays $10,000 in State and local taxes, well, then we'll remove that from the base that we will tax, because of the principle of federalism.

It seems to me that there can be no compromise with that fundamental principle, that fundamental tenet engrained in our Constitution and our constitutional system.

It seems to me that this administration is assaulting that fundamental tenet, and that is nonnegotiable.

The argument will continue in other committees and in the Halls of Congress.

Stay tuned. It is extremely important.

The subcommittee will adjourn.

[Whereupon, at 11:45 a.m., the subcommittee was adjourned.]

[The following additional material was submitted for inclusion in the record:]

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THE HONORABLE MARY MARSHALL

VIRGINIA HOUSE OF DELEGATES

ON BEHALF OF

THE NATIONAL CONFERENCE OF STATE LEGISLATURES

STATEMENT SUBMITTED TO THE SUBCOMMITTEE ON ECONOMIC STABILIZATION

COMMITTEE ON BANKING, FINANCE AND URBAN DEVELOPMENT

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 23, 1985

Mr. Chairman, Members of the Committee: I thank you for the opportunity to discuss the need to retain the deductibility of state and local taxes. My name is Mary Marshall and I serve as a member of the Virginia House of Delegates It is on behalf of the National Conference of State Legislatures and the Virginia General Assembly that I appear before you today.

Mr. Chairman, the Treasury Department---and possibly even the President---are proposing to end the deductibility of state and local taxes because they say they need the additional dollars raised to finance the tax reform that the nation wants. Thus, they're willing to accept double taxation on the nation's taxpayers, and to risk the basic constitutional balance of federal revenues and responsibilities and state and local revenues and responsibilities to finance what's being termed reform, simplification and fairness. I am here today to ask this committee to take every step possible to retain state and local tax deductibility. The issue of fairness would not be served by removing this tax provision. The effect of such a changed tax code would be hazardous to state and local governments. Treasury would have us believe that because of this deduction, $30 to $50 billion in tax revenues is lost to the federal treasury from the wealthy who avoid taxation through this deduction. Let's look at the facts.

We're not speaking here of investments in speculative oil drilling, or cattle ranching, or gold or silver trading: we're speaking of the fact that taxpayers across the United States each have to pay some amount in state and local taxes during the year. These dollars are what allow states and localities to provide a full spectrum of services, from police to parks, and parking lots, from fire protection to fireworks on the Fourth of July The dollars that escape federal taxation through this deduction are _already_ in the hands of state and local government _as tax payments_ not earning interest or return for the taxpayer. What is fair about treating this required payment as if it were some investment scheme, tax avoidance strategy or personal indulgence and submitting it to federal taxation? This isn't the money that the American people want taxed!

Treasury goes further and explains that this deduction only benefits upper income taxpayers. Yet the Congressional Budget Office has determined that over half of the deduction for state and local taxes accrues to individuals with incomes below $50,000. Only one-fifth of the value of the deduction goes to those who make more than $100,000 annually.

On the other hand, looking at what will happen to states and localities if deductibility _is_ ended reveals the problems associated with Treasury's proposal. The current fiscal crisis at the federal level is forcing budget decisions--it has already forced budget decisions that are eliminating aid to state and local governments. There's no doubt that the future holds even greater reductions in aid that effectively shift program responsibility to the state and local level. These added responsibilities will require greater revenues at the state and local level. The loss of deductibility will make those revenues harder to get, and jeopardize the possibility of state or local options to retain certain programs.

In addition, the states that will be most affected by this loss will be those that currently pay the greatest share of costs in joint state federal programs such as Medicaid. The states that now pay 50% of Medicaid costs will face the greater loss through eliminating deductibility than those that now pay only 40%.

States will be encouraged to shift their tax bases away from the income tax, which can be structured progressively, to business taxes or, when possible, severance taxes that would still be deductible. These incentives are not the intention of the Congress as it works to develop a new tax plan, yet they are the likely result of the loss of deductibility. The Northeast-Midwest Coalition has estimated that the cities of the 8 states with severance taxes would be required to pay an additional $613 per return if deductibility were lost, while northeast and midwestern states' citizens would be paying $1496 more per return.

One concern that must be pointed out is the "voting with your feet" approach that Treasury says will follow a repeal of deductibility. States have increasingly levied taxes more and more to provide support to urban areas whose tax bases are eroding. Thus greater problems in raising revenues by states will be reflected in lower aid available to local governments at a time when their own tax base--the property tax--will also be much more difficult to increase. The result will be much lower levels of services in urban areas, and possibly even migration to suburbs to avoid whatever tax increases can be passed.

Mr. Chairman, this Committee must spread the message about the kinds of effects the loss of deductibility will bring this country. Under the rhetoric of fairness, ending this provision simply to get additional revenues into a revenue-neutral tax reform plan, the Administration is proposing to redraw the balances between states and localities and the federal government. It is not a matter to be treated lightly but unfortunately it is one that may get lost in the shuffle of major tax reform or, worse, tied to this erroneous term of fairness and adopted.

I urge you on behalf of citizens who must support state and local governments as well as the federal government to respect the revenue systems and responsibilities of our governments, to retain the deductibility of state and local taxes, and to deal with tax reform in a way that addresses the problems and abuses in the current system, not by cutting out one major component that has been a keystone of the federal income tax since 1913.

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PSA

May 22, 1985

The Honorable John J. LaFalce
Chairman, Subcommittee on
Economic Stabilization
Committee on Banking, Finance
& Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of May 16 concerning the scheduled hearing in Washington, May 23, of your Subcommittee on Economic Stabilization. As your staff is already aware from telephone conversations late last week, representatives of the Public Securities Association are able to testify only with respect to issues on which we have a position.

As the national trade association of nearly 300 dealers and dealer banks active in underwriting tax-exempt securities of state and local governments--and, together, accounting for at least 95 percent of the new-issue market across the country--PSA has a strongly held and specific position on the proposed curtailment of the tax-exempt bonds for approximately 80 percent of state and local borrowing. I enclose a statement of our position with respect to these particular Treasury proposals affecting the municipal bond market and state and local finance.

We do not, however, have a position on the deductibility of state and local taxes. I am sorry that initial confusion about the subject of your hearing left you and your staff with the impression that PSA could be expected to testify on this subject. Unfortunately, we can not.

Sincerely,

Heather L. Ruth

Heather L. Ruth
Executive Director

HLR:ad

cc: Martin Gruenberg

Public Securities Association
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PSA

March 20, 1985

Ronald A. Pearlman, Esq.
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Main Treasury
15th & Pennsylvania, N.W.
Washington, D.C. 20220

Dear Mr. Pearlman:

Thank you for taking the time to meet with members and staff of the Public Securities Association on February 14, 1985 to discuss the potential effect of the Treasury tax proposal on state and local government obligations. We continue to oppose the proposal as it relates to municipal obligations. However, in an effort to promote positive and meaningful discussion we offer this letter in order to amplify our Association's views on the issues and pose a preliminary list of questions of interpretation raised by the proposal.

The Municipal Securities Division of PSA adopted a policy statement in January of 1984 that presents the views of our Association regarding the need for state and local governments to raise capital in the tax-exempt bond market. The policy states, in the section most pertinent to the discussion at hand, that:

> States and localities are most effective and responsive when they independently designate, as public purpose, projects that fulfill local needs in response to changing circumstances. Good public policy and sound Constitutional doctrine are compromised by Federal actions which

> restrict the ability of states and localities to define or determine the manner in which they will meet their capital needs.
>
> PSA strongly supports the fiscal independence of state and local governments and vigorously opposes any Federal action which, prospectively or retroactively, might result in withdrawal or diminution of the tax-exempt feature of their securities.

We also wish to reiterate our view that nomenclature such as "traditional" and "private purpose" when used to describe municipal securities does not contribute to clarity in the discussion of the proposal. By definition, municipal securities issued pursuant to provisions of duly enacted state enabling legislation and federal tax law are public purpose. Further, sound public policy demands that government periodically review and alter the services it provides its citizens. We believe that the dialogue concerning the Treasury proposals would be improved by the elimination of the use of these inappropriate terms.

During our meeting we agreed that the "one percent rule," as proposed, is unclear in a large number of fact settings. We agreed to provide you with a number of such examples which are representative of the general issues raised. Please inform us as to whether, pursuant to the proposal, tax-exempt obligations could be issued to finance the projects set out in the examples set forth below. In addition, please provide us, as you indicated you would, with your basis of analysis.

1) To provide needed public services, a municipal-owned utility finances the construction of an electric generating facility with tax-exempt revenue bonds which are to be repaid by the revenues derived from the sale of electricity to the utility's wholesale and retail customers. One such customer is an investor-owned utility and the municipal utility proposes to enter into a "take or pay" contract with that investor-owned utility for 10 percent of the facility's output during (i) its entire 30-year useful life or (ii) the first 10 years of that useful life. Alternatively, the municipal utility proposes to enter into a bulk sale agreement with a non-governmental customer for more than one percent of the facility's annual output at a rate below that available to the general public.

2) A municipality finances the construction of a water system with the sale of revenue bonds which are to be repaid from revenue generated by the system. It is expected that, during the life of the bond issue, ten percent of the system's capacity will be used by an industrial plant which will pay rates lower than those available to the public because of its volume purchases. Alternatively, a municipality finances an extension to its water system to provide service to a new industry. Although the extension is sized to accommodate additional users and any new business or customers in the vicinity would have access to the extension, there is no assurance that additional development or use will occur.

3) A municipal owned resource recovery plant is financed by revenue bonds to be repaid by revenue generated from the system. The plant is to be operated and maintained by employees of a non-governmental entity pursuant to a ten year management contract that does not meet the IRS ruling guidelines set forth in Rev. Proc. 82-13 and 82-14. Alternatively, the municipality determines cost and operating efficiencies would be achieved by leasing the plant to a non-governmental entity subject to municipal supervision of operations and public rate control.

4) A state issues general obligation bonds for the construction of a prison. The prison will be staffed and managed by the employees of a non-public entity pursuant to a ten year management contract that does not meet the IRS ruling guidelines set forth in Rev. Proc. 82-13 and 82-14.

5) A new concourse is to be financed at a public municipal airport by issuance of revenue bonds pledging the municipality's revenues from the entire airport. Five commercial passenger airlines are assigned gates in the concourse and pay prescribed rentals to the municipality, which rentals are a part of the revenues pledged to the bonds. Alternatively, a new runway is to be financed at the airport with the same pledge of revenue to repay the bonds. Ten airlines will use the runway and pay landing fees which are part of the pledged revenues.

6) A municipality issues a general obligation bond. The proceeds are to be used to expand and enhance the municipality's park system, including a doubling of the capacity of the municipal stadium. In addition to the

full faith and credit of the municipality, bond holders will have a first lien on various revenues generated by use of park facilities including, alternatively: concession fees from vendors whose concession is awarded annually; concession fees from the private contractor which, under a five-year-contract, manages the ice rink and collects user fees from skaters; lease payments from the local private university under a ten-year contract for use of the stadium for graduation ceremonies; specified income from the endownment of the local not-for-profit "Trees Conservancy" which donates tree plantings and certain tree maintenance services to the municipal park free of charge but also conducts "nature walks" open to the public at nominal charge. Alternatively, bond purchasers are informed of these revenues and the municipality states its intent to set them aside for repayment of their bond issue, but bondholders are not explicity provided a lien on the revenues; they would remain general creditors of the municipality in the event of insolvency.

7) A state issues a general obligation bond dedicated to environmental purposes. In this case, all facilities constructed with the proceeds will be owned and operated by the state, and there will be no revenues generated by the facilities. The state will, however, contract out all administration, environmental assessment, engineering design and construction management -- as well as actual construction -- of the system of facilities to one or more private contractors subject only to supervision and review by a gubernatorial appointee and his or her staff. The net before-tax profit or fees on these contracted services averages seven percent of the direct cost of personal services and other direct expenses of the contractor.

We continue to be troubled by your expressed view that a greater than *de minimus* nexus between state and local governments and private industry should bar the use of tax-exempt finance. We believe that public purpose is best determined by the ultimate public policy furthered by a project. It should not be arbitrarily denied because of any incidental benefit provided to a private entity. Two examples set out below illustrate our concern. However, we note that the same analysis can be made for the other types of financings that would be affected by the proposal.

Solid waste management is a serious issue facing many of our nation's metropolitan areas. Furthermore, state and local government's need to embark immediately upon new waste management strategies -- and abruptly curtail use of traditional methods -- is often precipitated by Federal regulatory action. Resource recovery plants, which turn garbage into energy, are an effective method for coping with the dwindling supply of land fill and the rising cost of energy. The state of the art in managing these plants continues to evolve. Especially at this stage of development of the technologies, the technical and management expertise required for such an undertaking is found principally in private industry. We are of the view that a locality which determines that it is in its best interest to enter into a long term management contract with a private corporation to provide management and staffing for a resource recovery facility, as well as design and construction, should not be penalized for making this decision by the loss of the tax-exemption. Further, curtailment of the private contractor's opportunity for participating in an equity share of such facilities serves at once to increase the amount of tax-exempt securities required to finance the plant and negates the positive financing incentive for the contractual "technology provider" to meet Federally dictated environmental standards.

Likewise, the effect of the proposal on voluntary, non-profit hospitals seems to be contrary to public policy considerations. Approximately 75 percent of the nation's general hospitals are voluntary non-profit institutions. The proposal would make them ineligible to issue tax-exempt securities. In our view, four scenarios may occur from such a development.

1) Hospitals, with a good credit rating, could borrow money in the taxable market, thus sharply increasing their interest costs which it can reasonably be expected would be passed along to those they serve.

2) Many hospitals would not have a sufficiently good credit rating to borrow money in the taxable market. It is likely that many of them, over time, would face deterioration of service capabilities, and eventually be:

3) Acquired by profit-making hospital organizations which would not be obliged to serve the indigent population or provide any particular array of costly, specialized services, or be

4) Acquired by state or local government to be operated directly as a public institution, in order to maintain

the tax-exempt financing option, with wide-ranging implications for long-run cost, quality and direction.

None of these alternatives seems satisfactory to us. All could, in one way or another, drive up the cost of health care at a time when cost containment is an issue of great importance.

We do not expect you to argee with our perspective. But we do hope that you will agree that these philosophical and historical issues merit serious and well-informed debate.

These examples demonstrate the potential for deleterious side-effects that the Treasury proposals, with respect to tax-exempt bonds would have on promoting general national policy in the areas affected. Many other examples could be cited, and will be, by PSA and by others with interest and expertise in each policy area ranging from docks and wharves to housing. Generally, when we in the industry refer to specific service areas currently benefiting in part from the issuance of tax-exempt securities, we see other public policy considerations overwhelming any alleged benefit that the proposal presumes to accrue from reducing the volume of tax-exempt securities.

Another aspect of the proposal which is unclear to us is the direction, purpose and effect of the requirement that issuers be state or local governments and not "on behalf of" issuers. For tax purposes, political subdivisions have been defined as having certain sovereign powers, such as the power to levy taxes, to exercise police power or the right of eminent domain. It is unclear whether the Treasury proposal would alter or add to this definitional concept. More particularly, it is unclear whether the proposed elimination of "on behalf of" issuers would attempt to alter fundamentally-established relationships and delegations of authority on the state or local level. Typically, such relationships and delegations have constitutional significance or relate to local decisions concerning effective implementation of policy. Here, as in the de minimus context, the proposal would suggest federal involvement in not only the determination of public purpose but in state and local governmental decisions concerning the most effective way of carrying-out that policy as well.

We have previously stated our disagreement with the proposal's recommendations concerning advance refunding and arbitrage. We would simply reiterate that we see no reason why advance refunding should be eliminated in all cases. In proper cases, advance refundings lower an issuer's borrowing cost or enable an issuer to remove restrictive bond covenants and thus provide necessary flexibility and cost-saving alternatives. If Treasury perceives abuses in this area, then curtailment of such abuses may be in order, but the complete elimination of the alternative should not be required. Similarly, we reiterate our strong belief that the arbitrage restrictions in the Treasury proposal go beyond any concept of curing abuses and would unnecessarily raise the cost of state and local borrowing.

As we agreed at our meeting, we will supply you with our analysis, when complete, of the effect of the Treasury proposal on interest rates for municipal securities. We hope to continue this dialogue and await your response to the issues raised herein.

Sincerely,

Jean J. Rousseau
Chairman

cc: Clayton F. Brown
JJR/arh

Public Securities Association
One World Trade Center
New York, New York 10048
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PSA

December 31, 1984

The Honorable Donald T. Regan
Secretary of the Treasury
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

The Public Securities Association urges the Department of the Treasury to reconsider its proposals regarding state and local government securities as advocated in "Tax Reform for Fairness, Simplicity and Economic Growth."

For more than a century, state and local governments have issued tax-exempt securities in order to provide their citizens with necessary infrastructure and other capital improvements judged by their elected officials to be of vital public purpose as defined by state law. These have included both general obligation bonds and revenue bonds funded through user fees and other financing arrangements geared to promote the public welfare through partnership with private entities, both not-for-profit and profit-making.

With the expectation of further reductions and eliminations in federal grant programs to states and localities and continued pressure on the local, state and federal levels to maintain taxes at current or reduced levels, the ability of state and local governments to borrow in the tax-exempt market is of paramount importance as a financial tool. In addition, the current Treasury Department proposal denies basic notions of Federalism and would severely restrict the sovereignty of the states.

The proposal establishes a category of municipal securities termed "private purpose non-governmental." This apparently refers to projects where there is a greater than de minimus connection to a non-governmental entity. This would include bonds issued to finance airports, ports, water supply facilities, electric generating facilities, resource recovery plants, health care facilities and low income housing among others, or about 62 percent of all municipal bonds issued in 1983. Such projects fall into the widely accepted and long established categories of public purpose. The Treasury's contention that such projects do not serve a public purpose at the state and local government level cannot be sustained and does a disservice to the discussion at hand. We note that when the same types of projects are funded at the federal level they are deemed to constitute a valid public purpose.

Indeed, the proposed requirement that no more than one percent of the revenue generated from a bond issue be used directly or indirectly by a private entity is unclear on its face. We are concerned that such a requirement will have the effect of limiting significantly the ability of states to issue general obligation and so-called "traditional" revenue securities on a tax-exempt basis. Depending on the definition and associated interpretations, such a provision could effectively curtail issuances representative of 70, 80, or even 90 percent of the municipal market in 1983. Such a broad attack on state sovereignty, cloaked in the name of tax reform, is repugnant.

Further, we believe that a partnership between government and private enterprise to provide for the needs of the citizenship is beneficial. The expertise of private enterprise has properly been combined with governmental public purpose to improve the quality of life at the state and local level and should continue to do so.

The apparent a priori belief that such a combination is wrong leaves us bewildered. Nevertheless, perhaps the gravest problem with the Treasury's restrictive definition of so-called "private purpose" is its usurpation of the fundamental ability of states and localities to determine what is necessary for the public good on the state and local level. We are dismayed that the Treasury Department believes it knows better what is in the best interest of states and localities than do the duly elected officials of state and local government; such a conclusion seems to be at odds with the Administration's early support for a "New Federalism."

Moreover, the proposal ignores the common sense reality that public purpose is an evolving concept. While building the Erie Canal may have been a public purpose over a century ago, airports and health care facilities along with economic development are identifiable public purposes today. Any static and arbitrary definition of public purpose -- such as that proposed by the Treasury -- utterly obstructs the ability of governments to meet changing circumstances and public needs.

In its attempt to mandate how and what types of securities a state or locality may issue, the Treasury Department proposal would deny "on behalf of" authorities the ability to issue tax-exempt securities. These authorities have issued tax-exempt securities for many years and essentially all of them are empowered by duly enacted state statutes. An earlier attempt by the Treasury Department to limit their ability to issue tax exempt bonds during the 1970's was withdrawn due to its unworkability. We believe that this proposal would limit the freedom of states and localities to determine how best to issue debt without providing any countervailing benefit.

On its face the proposal adds stringent restrictions to the issuance of bonds that even Treasury considers "governmental." In an apparent attempt to establish the premise with states and localities that the tax exemption is provided by the grace of the federal government, it would require costly and bureaucratic reporting of all bond issues to the federal government. This proposal smacks of federal government chauvinism. We are deeply concerned that it represents the first step towards requiring prior federal review of state and local government bond issues.

Additionally, the proposal to impose severely restrictive arbitrage limits, in addition to those currently in place, will require states and local governments to increase the size of bond issues to accomplish any given purpose. The proposed rebate of "excess arbitrage" to the federal government appears to us to be out of step with any theory of inter-governmental comity. The proposal to all but eliminate advance refundings will curtail state and local governments' ability to take advantage of reductions in interest rates as well as to alleviate overly restrictive bond indentures. As a result, the cost of finance for states and localities can be expected to increase, and this added cost will be passed on to local and state taxpayers.

In addition to proposing to narrow severely the scope of public purpose, the Treasury Department has declared its view that the tax-exemption of state and local government securities is an anachronism. The language of the proposal leaves one with the conclusion that in the view of Treasury tax-exemption is a mere "subsidy" provided to states and localities by the federal government that may be withdrawn. We strongly disagree, as do most local and state governmental officials. The Constitutional doctrine of reciprocal immunity prohibits state taxation of interest on U.S. Government obligations just as it prohibits federal taxation of interest on state and local government obligations. It is a doctrine established in the early years of the Republic and reaffirmed with specific respect to state and municipal debt in numerous Supereme Court decisions extending over almost a century. The recently developed assertion of Treasury that tax exemption of states and municipal debt is a "subsidy", "granted" by the Administration is just not so. Such an assertion can only detract from the quality of responsible debate on the subject.

Most alarming are statements of Ronald A. Pearlman, nominee for Assistant Secretary of Tax Policy, that Treasury is considering proposals to eliminate the tax exemption for all municipal securities including general obligation bonds. Mr. Pearlman stated that Treasury has the power to eliminate the tax-exemption on such securities and that the theory behind the Treasury tax reform plan would "... argue for totally removing the exemption for governmental obligations." The remarks of Mr. Pearlman indicate that the proposals of Treasury are ultimately intended to remove the tax exemption from all state and local government securities. In this light, the arguments made by Treasury regarding so-called public and private purpose municipal bonds assume the appearance of a mere subterfuge for its true goal of eliminating tax-exemption entirely. We are troubled by the misdirection of such an approach and dismayed by the lack of respect it demonstrates for state sovereignty, local government responsibility and the long history of Constitutional doctrine and legislation surrounding the subject.

There are other elements in the set of proposals which will impact the market for municipal securities and therefore the cost at which state and local governments can accomplish financing. These range from the proposed elimination of deductability of carrying charges for municipal bonds for financial institutions to the proposed indexation for inflation of interest on taxable securities. We do not oppose tax "simplification" or the reduction of marginal tax rates. We are very concerned, however, that the Administration, Congress and the public thoroughly understand the implications of any specific legislation which proposes to make such sweeping changes in the basic tax structure of the nation.

To that end, our Association, as well as a number of our members, are currently conducting and commissioning studies to estimate the impact of all these proposals on states and localities. To aid us in conducting these studies we request your Department to provide us with the methodology it utilizes to measure the alleged revenue loss brought about by state and local government securities, as well as proposed definitions of "direct and indirect use" and other ambiguous concepts put forward in the Treasury plan. When our analysis is complete, we will share the results of these studies with you, your staff, the Congress and the general public.

The Public Securities Association is the national trade association of dealers, brokers, and banks that trade, underwrite and sell municipal, mortgage backed and U.S. government securities. Last year PSA members underwrote over 95 per cent of the state and local government securities issued. We genuinely are eager to engage in a thoughtful dialogue with you and your staff regarding these proposals.

The Treasury proposal while not perfect, is an important attempt to serve the public interest. However, we are very seriously troubled by the components of the Treasury proposal which are directed at the issuance and use of proceeds of tax-exempt municipal bonds and urge the Treasury Department to re-evaluate them. We would be pleased to discuss these matters with you at your earliest convenience.

Sincerely,

Robert C. Brown

Robert C. Brown
Chairman 1984
Public Securities Association

Jean J. Rousseau
Chairman 1985
Public Securities Association

TAX SIMPLIFICATION AND INTERNATIONAL COMPETITIVENESS

TUESDAY, JUNE 11, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce.

Chairman LaFalce. The subcommittee will come to order.

For the past 3 months, this subcommittee has held hearings on the sectorial consequences of the tax simplification plan proposed by the Treasury Department last November. Those hearings inquired into the consequences of the plan for manufacturing industries, the construction and real estate industries, the banking industry, and the insurance industry.

Now, we have a new, revised tax reform proposal, presented and endorsed by President Reagan 2 weeks ago. As I speak, the computers are spinning to figure out the consequences of the President's revised plan for individual taxpayers, companies, and the economy as a whole.

What we can say with certainty at this point, and about which there can no longer be any disagreement, is that the Federal Government runs a very powerful industrial policy through the corporate Tax Code.

Donald Regan, upon releasing the original Treasury tax plan, stated, "We don't feel we should have an industrial policy disguised as tax policy." Well, a close examination of the administration's revised tax proposal reveals that a large portion of that tax-based industrial policy has been put back.

The revised tax plan would provide a form of accelerated depreciation less rapid than our present system, but significantly different than the system of real economic depreciation proposed in the original Treasury plan. The new plan would treat capital gains even more favorably than our present Tax Code, whereas the original Treasury plan would have indexed capital gains but treated them as ordinary income. The revised plan puts back a significant portion of the special tax breaks for the oil and gas industries that would have been eliminated by the original plan. I could go on, but I think the point has been made.

What we must do now is examine carefully the provisions of the administration's new tax proposal and see if they make sense from the standpoint of fairness, simplicity, and economic efficiency. That will be a process that will occupy the attention of the Congress for the next several months.

It is appropriate that the first effort of this subcommittee to examine the administration's new tax proposal focus on the issue that has occupied our attention for the past 2½ years—the international competitiveness of American industry.

Many industries, particularly in the manufacturing sector, are concerned that the revised plan's elimination of the investment tax credit and creation of a less rapid system of accelerated depreciation would undermine their ability to meet the challenge of foreign competitors which receive tax subsidies from their governments.

Several economists, on the other hand, have pointed out that the United States currently has a lower effective corporate tax rate than most of our trade competitors, as well as a more generous system of tax-based capital subsidies. Thus, some of those subsidies might be eliminated without damaging the competitive position of our industries.

In addition, some argue that the system of flexible exchange rates that has been in effect since 1974 would largely offset any increased costs for American export goods that might result from the elimination of tax subsidies. Also, eliminating tax subsidies might reduce the demand for credit, lower interest rates and the value of the dollar, and actually strengthen the international trade position of American industries.

Here to discuss these issues this morning is an exceptionally qualified panel of witnesses: Jerry Jasinowski, chief economist for the National Association of Manufacturers; Prof. Don Fullerton of the University of Virginia; and Edward Bernstein, international economist, the Brookings Institution.

Our first witness will be Mr. Jerry Jasinowski of the National Association of Manufacturers.

Mr. JASINOWSKI. Thank you.

Chairman LAFALCE. We will put the entire text of every panelist's remarks into the body of the record, and you may summarize those remarks.

STATEMENT OF JERRY JASINOWSKI, EXECUTIVE VICE-PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. JASINOWSKI. Thank you, Mr. Chairman.

Let me commend you for the attention you have put on the question of international competitiveness over the last 1½ years or more, and the effort you are making to bring to the current tax reform debate measurement of that same criteria. My statement deals with a wide range of issues associated with the impact of the President's tax proposal on business in the economy, but I will stress in my remarks those issues that go more directly to the international competitiveness issue.

In summary, the President's proposal would make the tax system here at home more evenhanded and fair, but it would tend to make the playing field more uneven with respect to American corporations operating in global markets.

It is clear that the President's proposal has many beneficial provisions with respect to the business community, capital investment and economic growth, including the reduction in corporate rates, the restoration of rapid depreciation, inflation adjustment accounting, graduated rates for small business, partial dividend deductibility, and reduction in capital gains taxes.

The President's proposal clearly is an improvement over Treasury I and will very strongly encourage small entrepreneurial firms. In addition, the rate reductions are a big plus for creating a more level playing field among corporations here at home in cutting taxes for noncapital intensive firms.

In particular, the administration is to be commended for restoration of an accelerated depreciation system with inflation indexing that would provide a competitive depreciation system in the long run; I stress the long run, Mr. Chairman, with respect to this new depreciation system because of the depreciation recapture tax.

The big problem with the administration proposal is that in the short run, it places an excessively high tax burden on capital intensive industries already experiencing enormous trade problems. It seems to me that given the economic security issues that are already raised because of a trade deficit, which last year was $123 billion and this year will climb to a minimum of $130 billion, and perhaps $150 billion, there are several dangers with respect to capital intensive firms raised by the President's tax reform proposal.

Let me just summarize three or four of these for you. First, the repeal of the ITC and the depreciation recapture tax leads to a net corporate tax increase of $120 billion and is too big a shock——

Chairman **LaFalce**. Over what period of time?

Mr. **Jasinowski**. Over 5 years—and is too big a shock to a narrow group of industries in a short period of time. In addition to slowing the rate of capital spending, which has already slowed considerably, as a result of an economic recovery which is performing rather sluggishly, such an abrupt tax increase on such a narrow part of the industrial spectrum is both unfair, and increases uncertainty by changing the rules so abruptly.

Second, there is no economic rationale of a clear nature for encouraging consumption at the expense of higher taxes on capital. Now, we all know the advantages with respect to the popularity of reducing taxes on consumption, and there are some who say that the tax reform plans can only increase the tax cuts for individuals as one party bids against the other in the tax reform debate. But I would argue that we have an important priority with respect to increasing investment in order to modernize American industries and make them more competitive.

Third, corporate cash flow is still weak despite the fact many stories are publicized about corporations not paying taxes. There are of course, some that do not, and I am not here to defend those at all. But if one looks at aggregate corporate profits in real terms, they have been on a two-decade decline, which has been only partially reversed by the 1981 tax cuts, major increases in profitability show up in the figures only starting in 1983.

In addition, the ratio of corporate profits to national income fell from 14 percent in 1965 to 6.5 percent in 1982, recovering to only 8.5 percent in 1983. In this respect, the decrease in the share of Federal revenue derived from corporations reflects decreases in profits relative to GNP.

Fourth, for a substantial number of industries, the cost of capital will be increased, and productivity growth slowed as a result, and manufacturing in the United States will be more difficult. This is likely to cause some acceleration in the spectrum of American industries that are experiencing a decline in manufacturing in this country.

Finally, with respect just to policies that impact international trade, the tax plan ultimately has a negative effect. The concentration of tax increases on manufacturing primarily hurts industries that are already vulnerable to import penetration while modifications to the foreign tax credit has adverse implications for American multinationals. It is apparent that this plan will aggravate an already unfavorable trade situation.

Mr. Chairman, as my statement has attempted to convey the administration's tax plan has a host of very beneficial provisions, the thrust of which are to make the American tax system and economy fair and more efficient here at home. The very large tax increases which occurred suddenly on a narrow segment of capital intensive firms that are already exposed to international competitive pressures is a major drawback and should be changed by the Congress.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you, Mr. Jasinowski.

[The prepared statement of Jerry Jasinowski on behalf of the National Association of Manufacturers [NAM], follows:]

National Association of Manufacturers

STATEMENT OF

JERRY JASINOWSKI

EXECUTIVE VICE-PRESIDENT AND CHIEF ECONOMIST

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

ECONOMIC STABILIZATION SUBCOMMITTEE

OF THE

HOUSE BANKING COMMITTEE

ON

THE TREASURY'S SECOND TAX SIMPLIFICATION PROPOSAL

JUNE 11, 1985

1776 F Street, N.W. • Washington, D.C. 20006 • (202) 626-3700

STATEMENT OF

JERRY JASINOWSKI

EXECUTIVE VICE-PRESIDENT AND CHIEF ECONOMIST

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

ECONOMIC STABILIZATION SUBCOMMITTEE

OF THE

HOUSE BANKING COMMITTEE

ON

THE TREASURY'S SECOND TAX SIMPLIFICATION PROPOSAL

JUNE 11, 1985

I am Jerry J. Jasinowski, Executive Vice-President and Chief Economist of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,000 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less that 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to express the Association's views on the Treasury's second tax simplification proposal.

I. INTRODUCTION

Major Features of the Proposal. The second tax reform program proposed by the Treasury (hereafter Treasury II), this time endorsed by the President, contains many of the same elements in the first proposal (hereafter Treasury I). In essence, it simplifies the overall tax code by removing implicit subsidies in order to lower the rate structure, a reversal of the historical situation in which relatively high tax rates coincided with a large number of implicit subsidies in the form of exemptions, deductions, credits, etc. In the process, however, Treasury II, like its predecessor, shifts the burden of taxation away from individuals and onto corporations. Over the first five years of the plan, corporate taxes would be raised by slightly less than $120 billion, or roughly 23%, in order to pay for reductions in individual taxes. Some of the corporate increases are transitory, with the result that the long run increases in corporate tax liability over the levels that would prevail under current law are somewhat less than the increases in 1986-1990.

The major elements of Treasury II with regard to the business sector can be briefly summarized.

o Repeal of the investment tax credit (ITC), as in Treasury I.

o Reduction of the corporate tax rate from 45% to 33%, as in Treasury I. At the same time, the reduction of individual tax rates to three brackets, 15%, 25% and 35%, effectively lowers taxes for some personal proprietorships and Subchapter S corporations.

o Restoration of rapid depreciation through the implementation of the Capital Cost Recovery System (CCRS), a considerable improvement over the lengthening of depreciation schedules through RCRS contained in Treasury I. The proposed CCRS system includes provisions for indexing the value of depreciable assets to inflation, and in this respect is superior to the ACRS system currently in force, although it is inferior to ACRS with the ITC except at high rates of inflation.

o Restoration of graduated tax rates on the first $75,000 of corporate income rcontained in current law; this provision would have been deleted by Treasury I. This provision is of considerable importance for small business.

o Transition to inflation-adjusted on LIFO accounting for inventories, without the LIFO conformity requirement. This will be beneficial in that it will mitigate excessive taxation due to overvaluation of inventories by accounting practices that fail to correct for inflation.

o Imposition of a transitory depreciation recapture tax. If this provision were instituted, corporations using accelerated depreciation would pay the same tax as though they had used straight-line depreciation for their capital assets.

o Enactment of deductibility of 10% of dividends paid out from corporate taxable income. Under current law, dividends are not deductible whereas under Treasury I 50% of dividends would have been deductible.

o Reduction of the effective rate of taxation on capital gains to 17.5%. Under current law, 20% of long term capital gains are taxable, whereas under Treasury I, 100% of capital gains would have been taxable.

Major Implications of the Proposal. Of the provisions listed above, the rate reduction, the substitution of CCRS for RCRS, inflation-adjusted inventory accounting, graduated rates for small business and the reduction in capital gains taxes are all beneficial to the business sector. The dividend deductibility provision has ambiguous effects for capital formation. The repeal of the ITC and the depreciation recapture tax are unequivocally detrimental to business. On balance, the negative features of the plan tend to outweigh the positive features with respect to business as a whole, as reflected in the increase in effective tax liabilities noted above. The plan can be expected to have the following effects on the economy and the tax structure as a whole.

o The distribution of tax liabilities is shifted toward corporations. In this respect, Treasury II is not neutral between corporations and individuals. Rather, it represents an increase in taxation of the corporate sector in order to subsidize decreased taxation of individual income.

o While Treasury II simplifies the tax system for individuals, it fails to address other elements of the tax code which are in need of reform. Rather than rectifying the existing biases in the tax code toward consumption, it exacerbates these biases.

o The projected macroeconomic effects are expected to be similar to Treasury I. In an econometric study of Treasury I using the Wharton model, this plan was found to substantially increase the user cost of capital, translating into lower rates of growth in investment. This in turn had a series of adverse secondary effects: lower productivity growth, higher unit labor costs, and higher inflation. The economy becomes both more labor-intensive and more service intensive; in essence, Treasury I engenders a process of "deindustrialization." Treasury II is likely to replicate most of these effects, although the magnitudes will be smaller.

o Treasury II has adverse implications for the overall competitiveness of American firms. The CCRS depreciation system is still better than depreciation laws in all but two major industrial countries, although not as good as ACRS with the ITC. However, the loss of the ITC and depreciation recapture result in a massive tax increase of capital intensive, goods producing manufacturing industries, the sectors in which the trade deficit has been largely concentrated. In this respect, the tax plan does nothing to counteract the effects of the exchange rate and high interest rates on manufacturing. The reduction in individual income taxes may also raise the trade deficit by increasing demand for imports. Further, the loss of the foreign tax credit will hurt American multinationals.

II. MAJOR PROVISIONS AFFECTING THE CORPORATE SECTOR

Repeal of the ITC. The Treasury's arguments for repeal of the ITC are that it permits the sheltering of unrelated income by virture of being excessively "front loaded," and that it can result in negative rates of taxation at low inflation rates. As discussed in more detail below, the indexation of depreciable property under CCRS partially compensates for the loss of the ITC. However, at low rates of inflation, ACRS with the ITC is preferable to CCRS with indexation. In essence, the repeal of the ITC must be evaluated in the context of prior moves by the Treasury to raise business taxes in order to pay for individual tax reductions. In this respect, the repeal of ITC constitutes a major source of additional revenue to the Treasury. Over the five-year period 1986-1990, the Treasury estimates a cumulative revenue gain of $139.7 billion, from repeal of the ITC.

The loss of the ITC is projected to increase the user cost of capital by substantial magnitudes. Moreover, numerous econometric studies have demonstrated that the ITC has been an effective policy from the standpoint of raising investment. Studies for the National Bureau of Economic Research by Feldstein, Auerbach and others have found a statistically significant relationship between the ITC and capital formation. A more recent study by Eckstein and Sinai found a 76% rate of return on investment from the ITC, i.e., for every dollar of revenue lost, the ITC generates $0.76 in additional investment. The loss of the ITC is therefore a serious loss to the business sector, and is likely to result in a substantial diminution of investment spending. Further, too sharp a change in the short run could hurt the current recovery, which has been dependent to some extent on business investment spending, and would undermine the competitive position of

American corporations. The ITC should therefore be retained or modified with special transition rules.

Changes in Corporate Tax Rates. In place of the current graduated rates of 15-18-30-40-46 on corporate income up to $100,000, Treasury II would establish rates of 15-18-25-33 on income up to $75,000. This is clearly preferable to the current tax system, and translates into a major tax reduction for business. On a cumulative basis, business cash flow is raised by about $154 billion over five years by the rate reduction. NAM fully supports this proposal.

Partial Dividend Deductibility. The proposal to allow 10% of dividends to be deducted is aimed at relieving double taxation of investment income. These arguments in favor of this proposal have to do with the fact that investment income is subject to taxation both at the corporate level and at the individual level; at the same time, it is argued that this would improve corporate debt-equity ratios, thereby generating greater investment. The efficiency of attempting to raise investment through raising equity values at the same time as investment is lowered through repeal of the ITC, however, is open to question. Nevertheless, partial dividend deductibility is in itself a favorable development insofar as the double taxation of dividends is reduced.

The Capital Cost Recovery System. The revised depreciation system, CCRS, is far preferable to the proposal contained in Treasury I, RCRS, which would have lengthened depreciation schedules and concentrated deductions toward the end of the equipment's useful life. In essence, RCRS, which was supposedly designed to reflect real rates of depreciation, represented a return to the useful life concept in force under the pre-ERTA ADR system. The major difference between RCRS and ADR was that the former incorporated inflation indexation, and thus would not have replicated the tendency of ADR to understate depreciation in an inflationary environment (ADR is estimated to have overstated taxable profits by up to $16 billion a year during the 1970s).

By comparison, the CCRS system is closer to ACRS in its conceptualization: it provides "front loaded" depreciation write-offs over relatively short asset lives. CCRS does expand the number of asset categories and lengthens most depreciation schedules. Thus in place of the ACRS 3, 5, 10, and 18-year categories, CCRS would establish six classes with depreciation schedules set at 4, 5, 6, 7, 10 and 28 years. With completely stable prices, CCRS would therefore be slightly inferior to ACRS. However, complete price stability is not a realistic projection for the economy, which is projected to undergo moderate inflation in the 4% and 5% range over the next few years. Because CCRS includes inflation indexation, it is substantially preferable to ACRS at high rates of inflation and at least equal to ACRS at modest rates of inflation.

For instance, with a 5% inflation rate, 100% of the inflation-adjusted value of an ACRS 3-year asset is recoverable in five years under CCRS, while only 94% is recoverable in three years under ACRS. For ACRS 5-year assets, the corresponding figure is 90.4%. For ACRS 10 and 18 years assets, the figures are 81.9% and 71.5%, compared to 100% under CCRS. The only disadvantage of CCRS relative to ACRS is that the depreciable lives are longer, with the result that the short-term benefits in terms of increased cash flow are not as high. Whether corporations are better off taking 100% of depreciation over a slightly longer period or less than 100% over a shorter period is a matter of individual preference, but on the whole, the CCRS depreciation system is not objectionable. NAM commends the administration for restoration of the accelerated depreciation system, and for instituting inflation indexation with respect to capital assets. Nevertheless, as detailed below, the CCRS depreciation system is not as beneficial to capital investment as the combination of ACRS and the ITC currently in force.

TABLE 1

Value of Depreciation Benefits, in Current Dollars

Taxable Year	ACRS	CCRS	ACRS	+	ITC
1	$ 250	$ 275	$ 250	+	80
2	380	419	380		
3	370	198	370		
4	0	93	0		
5	0	80	0		
Totals:	$1,000	$1,065	$1,000	+	80

Note: While CCRS depreciation takes place over four years, the mid-year convention causes depreciation to be extended for an additional year. ITC is based on the choices of an 8% credit under basic adjustment.

While CCRS is arguably equal to or preferable to ACRS, it is however, normally inferior to ACRS with the ITC. A simple comparison of benefits illustrates this point. Table 1 gives depreciation benefits in nominal dollars for ACRS 3 and 5 year property (CCRS 4 and 6-year property) for ACRS, CCRS and ACRS + ITC. The asset is hypothetically valued at $1,000 in the first year, and qualifies for the full ITC.

Thus with a 5% rate of inflation, ACRS + ITC is unequivocally superior to CCRS, while both are superior to ACRS alone. Only at rates of inflation approaching 10% is CCRS equal or better than ACRS + ITC, and then only after a longer period. With 5% inflation, ACRS + ITC results in a writeoff of $1,080 in three years for the hypothetical asset, while CCRS results in a writeoff of $1,065 over five years. After three years, the CCRS writeoff totals only $931, compared with $1,080 under ACRS + ITC. In this context, it is readily apparent that the benefits of inflation indexation under CCRS do not outweigh the loss of the ITC.

A significant feature of CCRS is that according to the Treasury's own estimates, it results in slightly higher corporate tax liabilities than ACRS. Excluding for the moment the loss of the ITC, revision of depreciation schedules lowers corporate tax liabilities in 1987, but then raises them by a cumulative total of $26.4 billion in 1988-90. The major cause of the increase in corporate liabilities appears to be the lengthening of depreciation schedules and the resulting decrease in annual deductions in the out-years at low rates of inflation.

Capital Gains Revision. There are a series of revisions to the taxation of capital gains, but on the whole the effects are similar to current law. The component of long term capital gains that can be excluded from taxation is reduced from 60% to 50%, but because of the lowering of individual tax rates to a maximum of 35%, the effective rate of taxation of capital gains is reduced from 20% maximum to 17.5%.

This is a beneficial development. Previous reductions in capital gains taxes, for instance the increase in the exclusion in 1978, were associated with greater investment and an increase in the real volume of revenues derived from the capital gains tax. In general, preferential taxation of capital gains encourages investment and saving. It therefore provides a useful offset to other provisions in the tax code which discourage investment and encourage consumption. The reduction in the effective rate of capital gains taxation is particularly welcome inasmuch as Treasury I had proposed treating capital gains as ordinary income, an ill-considered measure which would have worked against investment.

Indexation of Inventory Accounting. The proposal to index the accounting of inventories to inflation is a highly beneficial one, which goes a long way in redressing the excessive taxation of corporate income that took place during the 1970s. Under current law, corporations can use either FIFO or LIFO accounting methods for inventories. Since LIFO procedures result in a higher input cost for goods sold, it reduces corporate taxable income from inventories and largely corrects for the effects of inflation on effective taxation of inventory profits. Corporations have been deterred from using LIFO, however, by the conformity requirement which obligates them to also use LIFO in financial statements for credit purposes and reports to stockholders. Because of the conformity requirement, many corporations have instead used FIFO accounting, which artificially inflates profits by failing to adjust for the effect of price changes on inventories. Unfortunately, because FIFO raises nominal income, it also raises tax liabilities.

The effects of overvaluation of inventories on corporate taxes were particularly marked during the 1970s, when high inflation rates were in evidence. For instance, in 1979-80, overvaluation of inventories raised taxable corporate profits by more than $40 billion per year, more than twice the increase associated with understatement of depreciation. Although the decline in inflation has mitigated this effect, the use of FIFO accounting by roughly two-thirds of corporations to which these provisions are applicable has continued to raise effective tax liabilities. For instance, in 1983, overvaluation of inventories raised taxable corporate profits by $11.2 billion.

The implementation of indexed FIFO would effectively correct for this distortion. Thus the erosion of corporate profits by overvaluation of inventories would be ended, and corporations would be protected from the effects on inflation without having to rewrite their financial statements according to the LIFO conformity requirement. A shift to LIFO or indexed FIFO by firms currently using FIFO would raise corporate cash flow by approximately $4.5 billion per year.

Depreciation Recapture. Despite the additions to depreciation deductions under CCRS, Treasury II incorporates a countervailing and highly undesirable proposal to recapture 40% of "excess" depreciation taken before the corporate rate reduction goes into effect. This "excess depreciation" would be included in income over a three-year period from the inception of the plan, at rates of 12%, 14% and 16% per year, respectively. The net effect is to roughly approximate the results of using straight-line depreciation rather than ACRS.

The purpose of this provision is ostensibly to prevent corporations from paying "excessively" low taxes by using ACRS until the lower rates go into effect, thereby achieving large deductions for depreciation while the corporate tax rate is still 46%, and deducting smaller amounts after the tax rates falls to 33%. Unfortunately, the major effect of this plan is to substantially reduce depreciation deductions during the period in which depreciation recapture is in force. Although the resulting tax increases are short term in nature, they are nonetheless substantial. Depreciation recapture raises some $56.5 billion from corporations over the period 1986-89. When depreciation recapture is added to the loss of the ITC, these provisions for outweigh the effects of the corporate rate reduction, translating into a major increase in business taxes. A singular aspect of the depreciation recapture provision is that like the earlier RCRS proposal, it seems to be designed to deny depreciation benefits to business in the short term. This practice contrasts sharply with the administration's own recognition in 1981 when ERTA was passed that accelerated depreciation was needed in order to protect business from the understatement of depreciation by inflation and to stimulate additional capital formation. Provisions such as RCRS and depreciation recapture explictly contradict the administration's prior commitment to stimulating capital formation. It is also a retroactive change in investment rates that will greatly increase business uncertainty.

III. IMPLICATIONS FOR THE TAX STRUCTURE

In one critical respect, the aggregate implications of Treasury II for the overall tax structure are similar to Treasury I: the plan pays for reduced taxes on individuals through increased taxes on business. Similarly, on the business side alone, the plan resembles Treasury I inasmuch as it pays for a reduction in tax rates through reductions in credits, deductions, and other base broadening measures. The major effects of the plan on individual and corporate liabilities

TABLE 2: Revenue Impact of Tax Simplication

Provision	Revenue Increase or Decrease ($billion)
INDIVIDUALS:	
Rate reductions	- 262.6
Changes in exemptions	- 193.1
Changes in exclusions	25.8
Rescission of state and local tax deduction	148.9
Changes in loss on tax abuses	8.1
Other simplification	28.5
Total of above:	- 244.4
CORPORATIONS:	
Rate reductions, with graduated rate structure and change in minimum tax	- 155.4
Depreciation changes	26.0
Repeal of ITC	139.7
Inventory indexation	- 15.9
Depreciation recapture	56.5
Income measurement	45.8
Total of above:	98.7
TOTAL CHANGE IN RECEIPTS:	
Individual	- 131.8
Corporate	118.4
Excise	1.7
Total:	- 11.7

Source: U.S. Treasury

are summarized in Table 2, which gives the cumulative impact on revenue over the five-year period 1986-1990 of selected provisions on Treasury II.

As Table 2 indicates, the plan would lose some $131.4 billion in receipts on the individual side, while gaining $118.4 billion from corporations. This is not as skewed a result as the first Treasury plan, which would have raised corporate taxes by $200 billion over the same period, and raised nearly $400 billion from corporations over a ten-year interval. However, it represents an unambiguous shift in the distribution of tax liabilities toward business.

Individuals and Corporations. The rationale for shifting the tax burden onto the corporate sector remains obscure. Historically, corporations have paid a considerably greater share of their income in taxes than individuals. Disregarding for the moment contributions for social insurance and state and local taxes, the ratio of Federal tax liabilities to corporate profits (adjusted for capital consumption and inventory valuation) has varied between a peak of 55.9% in the early 1950s and as high as 54% as recently as the late 1970s, with a low of 33.6% in 1983, averaging well over 40% for the postwar period. By comparison, individual payments of Federal income tax in relation to personal disposable income have averaged in the area of 11% to 12%. In other words, the ratio of Federal tax to income has been roughly three times as large for corporations as for individuals.

Part of the rationale for raising taxes on corporations is that the share of Federal revenue derived from corporations has undergone a secular decline since the early 1960s. However, this ignores two factors. First, an increasing share of corporate pre-tax cash flow has been devoted to social security tax payments. Secondly, the share of national income to pre-tax corporate profits has also undergone a chronic decline since the 1960s. The ratio of corporate profits to national income fell from 14.0% in 1965 to 6.5% in 1982, recovering to only 8.5% in 1983. In this respect, the decrease in the share of Federal revenue derived from corporations is primarily a reflection of decreases in the share of GNP comprised by corporate profits.

A further reason for not raising corporate taxes as proposed in Treasury II has to do with the level of real corporate profits. From 1966 onward, real corporate profits in constant dollars declined consistently until the late 1970s. Real profits only surpassed their 1966 level in 1978. Thereafter, profits fell consistently until 1983. In 1982, real after tax profits were more than 30% below their 1978 level. Thereafter, the implementation of ACRS has been critical in restoring higher levels of profitability. By 1983, profits had regained their 1978 level. However, this was only 7.5% higher than their level of 1966. The evidence is therefore that the American economy has undergone a serious long term erosion in real profits over the past two decades. It is partially as a result of corporate tax cuts such as ACRS that this erosion has been reversed, although other factors such as the recovery itself were also involved. Raising corporate taxes by the magnitudes proposed in Treasury II would exacerbate the long-term problem of depressed profitability.

Changes Within the Corporate Sector. Within the Corporate sector, the major implication of Treasury II is to shift the distribution of liabilities toward more capital-intensive firms while reducing taxes on service-oriented or non-capital intensive companies. The rationale underlying this distributional change has to do with the current inequality in tax liabilities across sectors. Firms which are unable to take advantage of accelerated depreciation on tax credits are likely to pay taxes at or near the statutory maximum. Conversely, corporations that possess larger volume of depreciable assets have been able to reduce their taxes substantially below the maximum rates. The base broadening provisions of Treasury II would largely remedy this inequality and has merit on equity grounds.

However, it should be noted in this context that shifting to an income-based system of corporate taxation with fewer investment subsidies is likely to work against capital formation. Several recent econometric studies have demonstrated a statistically significant relationship between the ITC, changes in depreciation, and business fixed investment. Further, the ability of targeted investment incentives to stimulate capital formation is considerably greater than general, diffuse, non-targeted measures such as rate reductions. Accelerated depreciation and the ITC have been estimated to provide a rate of return in investment in the area of 75% to 85%, while a corporate rate cut generates an increase in investment of less than 20%. In this respect, the need to retain investment subsidies is underlined by the fact that the United States has had one of the lowest ratios of fixed investment to GNP among the industrial countries.

Taxation of Income and Consumption. While Treasury II has been billed as a major reform of the tax system, it completely fails to address one crucial element in the tax code, the distribution of taxes relative to income and consumption. Historically, the tax system in the United States has been heavily weighted toward taxing income rather than consumption. Of total revenues received by the Federal, state and local governments in 1981, some 46.2% was derived from income taxes while only 17.6% was derived from consumption taxes (the remainder is comprised primarily by social insurance contributions). By comparison, the proportions are substantially more weighted toward consumption in other industrial countries. The share of revenues derived from consumption taxes in 1981 ranged from 24% in Italy and the Netherlands to 27% to 29% in Germany, France and the United Kingdom, and 33% in Canada. Similarly, the share of revenues derived from income and profits taxes in the other industrial countries has typically been much lower than in the United States. For instances, in Germany, 29% of revenues are derived from personal income taxes and 5% from corporate taxes (a total of 34%), while in France 13.3% are derived from personal income taxes and 5% from corporate profits, a total of 18.3%.

Table 3 gives the share of total taxation comprised by income and consumption taxes, and the ratio of consumption to income taxes in nine OECD countries for the period 1977-79. The United States has clearly had a tax system that encourages consumption to a far greater degree than tax codes overseas.

TABLE 3

Taxes on Income and Consumption, Industrial Countries, 1977-79

Country	Income Taxes % of Total	Consumption Taxes % of Total	Ratio, Consumption Tax to Income Tax
France	18.0%	31.0%	172.2
Austria	26.3	32.3	122.8
Germany	35.8	36.3	101.4
Italy	29.7	28.2	94.9
Netherlands	32.7	25.6	78.3
Canada	45.0	32.3	71.8
United Kingdom	40.3	26.5	65.8
Belgium	40.7	26.4	64.9
United States	46.2	16.9	35.5

Source: Grace Commission

Further, there is an inverse relationship between the propensity to tax consumption and the personal savings rate. Of the countries listed in Tables 3, the savings rate for the period 1977-79 was only 6.2% in the United States, compared to 15.0% in Austria, 14.1% in Italy, 14.0% in Germany, 13.5% in the Netherlands, 13.1% in France, 11.7% in Belgium and 11.4% in Canada. While other factors also determine savings rates, the tax system in the United States has repeatedly been demonstrated to be partially responsible for the low savings rate in this country.

The failure of either of the Treasury proposals to address the problem of excessive taxation of consumption relative to income represents a major shortcoming. In essence, while Treasury II achieves greater neutrality across sectors, it is not neutral on the consumption-income issue. A neutral tax system would tax income and consumption about equally. The Treasury plan further skews the tax base toward income, and in this sense can be viewed as an implicit consumption subsidy.

IV. MACROECONOMIC IMPLICATIONS

The Treasury plan is ostensibly depicted as a pro-growth proposal. The cut in marginal personal tax rates is supposed to stimulate greater economic activity. However, the evidence on this point is problematical at best. The relationship between marginal personal tax rates and aggregate economic activity in and of itself is undemonstrated, although it is possible that a large personal tax cut ratified by a more expansionary monetary policy would generate a rise in demand, thereby raising real GNP. On balance, the Treasury proposal is expected to be neutral with respect to economic growth.

The best econometric evidence on the effects of the tax simplification proposals on the economy that NAM has had access to is provided in a study by Wharton Econometrics. The Wharton U.S. annual model was simulated for a period of ten years, incorporating the policy changes proposed in Treasury I and holding the other policy assumptions constant. The major conclusions of the Wharton simulations were as follows:

1] The shift in the burden of tax liabilities toward corporations, the loss of the ITC and the mitigation of depreciation benefits all produce a sharp increase in he user cost of capital. Under Treasury I, the rise in the user cost was in the area of 25% to 30%.

2] The rise in the user cost of capital generates a sharp fall in capital formation relative to current law. Business fixed investment was found to be about 5% lower by the end of the simulation.

3] The economy becomes more labor-intensive. Because of the increase in the user cost of capital, business substitutes into labor. For this reason, employment rises relative to current law.

4] Because of the decrease in capital formation and the increased substitution into labor, the capital-labor ratio falls relative to the baseline. This generates a corresponding fall in productivity growth.

5] The combination of higher employment (which yields higher wage increases) and lower productivity (which raises unit labor costs) translates into a higher rate of inflation.

6] The output mix is shifted away from investment and in favor of consumption. On a sector-by-sector basis, real output falls relative to current law in manufacturing, durable goods, and capital equipment. Real output is somewhat higher in other areas, primarily in services and non-manufacturing sectors. The net effect is that the sectoral mix of output shifts away from manufacturing; in essence, Treasury I produced tendencies toward "deindustrialization."

7] Treasury I was found to be neutral with respect to real GNP. Real GNP was essentially the same under current law and Treasury I. What changed was the components of GNP. On the supply side, a greater share of economic activity was comprised by non-manufacturing activity while a greater share of factor inputs to production consisted of addition of labor.

The macroeconomic implications of Treasury II are likely to be fairly similar to Treasury I inasmuch as the underlying thrust of both proposals toward corporate taxes is essentially comparable. Differences between the two are more likely to be differences in magnitude than in the direction of the economy. The differences in magnitude are reflected primarily in the fact that the increase in corporate taxes under Treasury II is only about three-fifths the increase under Treasury I, while some of the more deleterious provisions of Treasury I such as RCRS are eliminated. Under the circumstances, the macroeconomic effects of Treasury II should be in the range of one-half to three-fifths the magnitude of Treasury I. Thus the increase in the user cost of capital would be in the range of 15%, and the decrease in capital investment relative to current law would be in the area of 3%. These outcomes are clearly unfavorable for the economy, but less so than what could be expected under Treasury I. The ancillary effects of Treasury I—secondary implications from the rise in the user cost of capital—are also likely to be in evidence. The economy would exhibit lower productivity, shifts toward labor inputs, shifts in the output mix toward services, and a deterioration in industrial activity relative to trend. Capital-intensive manufacturing industries would experience an increase in their tax rates and their user cost. Non capital-intensive industries would do better, as would services and domestic trade.

V. IMPLICATIONS FOR INTERNATIONAL COMPETITIVENESS

Linkages between the tax system and international competitiveness are of necessity somewhat indirect. Nevertheless, changes in the tax law can be used in order to offset developments in the trade sector, or influence the relative competitive position of domestic firms. Similarly, specific subsidies such as the foreign tax credit (hereafter FTC) affect the profitability of American corporations doing business abroad. From this perspective, Treasury II ultimately has a negative impact. While the change in the depreciation laws still leaves the United States with a relatively favorable cost recovery system vis-a-vis comparable systems abroad, the concentration of tax increases on manufacturing primarily hurts industries that are already vulnerable to import penetration, while the modifications to the FTC have adverse implications for American multinationals.

Depreciation Law Changes. During the 1970s, the depreciation system in the United States was generally inferior to cost recovery provisions in the other industrial countries. While the useful lives of equipment specified under ADR were not necessarily larger than cost recovery periods abroad, the tendency of ADR to understate depreciation during periods of high inflation put American firms at a serious competitive disadvantage vis-a-vis foreign countries that had lower inflation rates or accelerated depreciation. The 1981 reform of depreciation schedules largely reversed this problem. Table 4 gives depreciation laws in eleven major industrial countries as of 1981. The figures for the United States are for ACRS 5-year property, and do not reflect the changes introduced by TEFRA in 1982.

As Table 4 indicates, depreciation laws in the United States were unequivocally superior to comparable laws in Japan, Germany, Australia, France, Italy and several smaller European countries. Only Canada, which has a two-year recovery system with an investment tax credit, and Sweden which permits first year expensing with a 20% special allowance were unequivocally superior; the first year expensing system then in force in the United Kingdom (now being phased out) was arguably preferable during periods of high inflation. Under RCRS as proposed in Treasury I, the cost recovery system in the United States would have become inferior to that in several of the major industrial countries. On the other hand, despite the loss of the ITC, under CCRS with indexation the United States would, at least in the long run, continue to enjoy a better depreciation system than most of its competitors. In the short run, however, depreciation recapture would damage the American competitive position. Without full ACRS deductions in the interim, the United States would drop behind Italy (see Table 4) in terms of the quality of its depreciation laws.

TABLE 4

Capital Cost Recovery in the Industrial Countries (As of 1981)

Country	Representative Cost Recovery Period	First Year	Third Year	Seventh Year
United Kingdom[1]	1	100.0	100.0	100.0
Canada[2]	2	61.7	108.2	108.2
Sweden[3]	1	120.0	120.0	120.0
Italy[4]	6	25.0	75.0	100.0
Australia[5]	8	28.0	48.0	88.0
Japan[6]	10	20.6	50.0	80.1
France[7]	8	31.3	67.6	94.6
Netherlands[8]	8	37.1	57.1	97.1
Germany[9]	10	25.0	57.8	86.7
Belgium[10]	8	26.0	54.8	95.0
United States[11] (ACRS & ITC)	3-5	36.7	79.7	121.7

Source: Price Waterhouse

Notes to Table:

1. In the U.K. full cost recovery was the first taxable year for most industrial machinery and equipment until 1985. The capital allowance is now being phased out.

2. Canada has an investment tax credit of 7%, 10% or 20% of the cost of new buildings and machinery and equipment to be used in manufacturing and processing and other specified activites. The applicable rate of investment tax credit is determined by the locations in which the property is to be used. Investment in the more populous and economically well-to-do areas in Canada will generally only qualify for the 7% rate. This example assumes a 7% investment tax credit. The cost of the property acquired is reduced for tax purposes by the investment tax credit received. Canada permits 50% of the cost (for tax purposes) of machinery to be used in manufacturing and processing to be recovered the first year and the other 50% in the following year. A 46% combined Federal and Provincial tax rate is assumed.

3. 50% of a Swedish corporation's adjusted pre-tax income may be allocated to a reserve for future investment in fixed assets. Where the acquisition is deemed to have been made from this reserve, full cost recovery occurs before the investment is made. A 20% special allowance is also available for acquisitions made from the reserve.

4. Straight-line depreciation with 15% additional depreciation in each of the first three taxable years.

5. Depreciation in Australia is based on an estimate of "effective life," and taxpayers may elect to use either the prime cost (straight-line) method or the 150% diminishing value (declining balance) method. In addition, an 18% investment allowance (20% for assets acquired before May 1, 1981) for new property may be deducted from the tax base in the year the property is ready for use. The Commissioner of Taxation publishes rates of depreciation which commonly apply to specified categories of industrial machinery and equipment, and these rates would normally apply in the absence of specific determinations of the effective life. This example assumes the asset has a 10-year life and is depreciated on a straight-line basis.

6. A declining balance method of depreciation is used. The current rate is 20.6% on an asset with a 10-year life. Calculation assumes asset is written off in year 10. In certain instances, not considered here, additional first year allowances and accelerated depreciation are allowed.

7. Example assumes that the asset has an 8-year life and is depreciated under the 250% declining balance method with an adjustment to the straight line method after the fifth year. Although not considered, effect may be given to multiple shift operations by reducing the service life of the assets.

8. Straight-line depreciation on an asset with a 10-year life. A 7% premium for new investment in fixed assets is given in the form of an investment tax credit. If the total of the premiums exceeds the tax liability, the excess of the premium over the tax liability is payable in cash to the taxpayer. In addition, bonus premiums from 0.25 to 6% for small investments are available. This calculation assumes machinery is eligible for this 6% bonus premium. The tax benefit for the premiums is computed using a 40% corporate tax rate.

9. Assumes the asset has a 10-year life and is depreciated under the 250% declining balance depreciation.

10. Assumes asset has a 10-year life and is depreciated under the double declining balance method of depreciation which is switched to the straight-line method after the fourth year. As a temporary measure to promote investments, a one-time special deduction of 15% is allowed on certain acquisitions of fixed assets. The special deduction will be allowed to the extent that investments in fixed assets exceed the average annual investments for a specified base period. The 15% deduction is only applicable to a maximum of 40% of the total new investments. For purposes of this example, it is assumed that the special deduction represents 6% of the asset cost.

11. The computation assumes that the regular 10% investment tax credit applies but that the assets do not qualify for the additional 10% investment credit for energy savings property or for the 1% ESOP credit. The tax benefit of the investment credit is computed using a 46% corporate rate. Therefore, the investment credit increases the capital cost recovery by 21.7% for the first year.

Notes to Table 4 courtesy of Price Waterhouse.

The loss of the ITC is, however, still a serious problem with respect to the problem of "offsourcing" (relocation of production facilities abroad), especially to Canada. The new Canadian government Prime Minister Brian Mulroney, has reversed its predecessor's long-standing opposition to foreign investment, and has openly invited American firms to establish subsidiaries in this country. In this respect, the Canadian depreciation system is clearly superior to CCRS, with or without depreciation recapture.

The Trade Situation. Probably the most adverse aspect of Treasury II in the international trade area is the extent to which it concentrates the increase in corporate taxation in sectors that are highly vulnerable to trade, or more specifically to import penetration. Tables 5 and 6 give selected indications of American trade performance since 1980.

Table 5 gives exports and imports as a share of domestic production and consumption, respectively, for selected industries. Since 1981, exports have fallen sharply as a share of production, particularly in instruments, aerospace, machine tools, and even in high-technology in which the United States enjoys a comparative advantage. During the same period, imports as a share of domestic consumption have surged, with particularly marked increases in certain consumer non-durables, general industrial machinery, machine tools and even in computers and semi-conductors. Table 6 gives the trade deficit by sector. In 1984, the United States ran a massive trade deficit ($88.8 billion) in manufactured goods. The trade accounts were in deficit in almost every manufacturing sector. The causes of this situation of course have had to do primarily with the 70% appreciation of the dollar since mid-1980 and the rise in domestic spending during the early stages of the recovery, which bid up demand for imports.

Under the circumstances, it is readily apparent that Treasury II will only aggravate an already very unfavorable trade situation. By lowering income taxes, Treasury II will produce a shift in the output mix toward consumption, thereby raising demand for imports, exacerbating the trade deficit. At the same time, by raising taxes on capital-intensive manufacturing firms, Treasury II will make it still more difficult for these industries to compete with foreign imports. The seriousness of this problem becomes clearer when it is borne in mind that the bulk of the corporate tax increases under Treasury II are derived from the repeal of the ITC and depreciation recapture, which mainly impact on goods-producing sectors. For this reason, Treasury II is likely to compound the current external trade difficulties faced by the United States.

The Foreign Tax Credit. Under current law, the foreign tax credit, within limits, can be applied on the basis of an average of all the other countries in which a company receives income. The limit on the applicability of the FTC is measured on the basis of the portion of Federal tax corresponding to the portion of foreign taxable income that is worldwide taxable income. Treasury II would amend the limitation to a per-country basis. In essence, corporations would be prevented from averaging their income from foreign countries with tax rates above and below rates in the United States. Ostensibly, this provision is aimed at preventing corporations from making investments in low-tax countries for tax shelter purposes, since corporations with excess foreign tax credits can then average these rates against income from high tax countries to avoid paying Federal taxes on the low-tax-country income not eligible for credits.

There are several arguments against this proposal. To begin with, the system results in needless administrative complexity. It forces both the American multinational and the IRS to develop exceedingly complex country-by-country tax records. Second, it discourages investment in low-tax countries. Any number of foreign countries, particularly the emerging city-states of the Far East, have established very low tax rates in order to attract foreign investment. Under Treasury II, American tax law would work against investment in these countries, and would actually militate in favor of limiting investment to countries with tax rates equal to or higher than the United States. Third, and more importantly, Treasury II would prevent corporations from prorating losses in individual countries against their overall foreign source income. Instead, corporations would be obliged to carry losses forward against future income in the same country in which the initial investment is made. The result is that in cases where investments are long-lived and do not make money until several years after the initial allocations are undertaken, corporations would be forced to sustain losses over extended periods without being able to deduct these losses from the overall foreign source income.

In essence, the proposed sourcing requirements in computing the FTC limitation amount to a major tax increase on multinational corporations. On a cumulative basis, the use of the per country limitation for the FTC would raise corporate taxes by $13.3 billion over five years. When this is added to other international tax provisions affecting corporations, corporate taxes would be increased by $18.5 billion over the same period.

IV. CONCLUSIONS

Treasury II contains elements that are both beneficial and detrimental to the business sector and the economy as a whole. The general thrust of tax reform is a move in the right direction, making the system more equitable. The rate reductions are a big plus for creating a more level playing field domestically among corporations and cutting taxes for non-capital intensive companies.

However, the business provisions do not achieve greater simplicity and on balance have several adverse economic effects. They greatly increase uncertainty during the transitional period. Most importantly, by raising corporate taxes by $120 billion in order to subsidize an increase in consumption, the plan raises the cost of capital, decreases productivity growth, and aggravates an already deteriorating trade picture. Treasury II would make the tax system more evenhanded domestically, but would tend to make the playing field more uneven with respect to American corporations operating internationally.

Given the number of simultaneous good and bad changes in Treasury II, it is not possible for the NAM to support or oppose the package as a whole at this time. We will be examining the degree of our support as the debate progresses.

With respect to specific provisions, the NAM at this time oppose:

o Raising business taxes over current levels, particularly when the motive is to subsidize consumption.

o Repeal of targeted investment incentives such as the ITC or accelerated depreciation.

o Reductions in effective depreciation rates through provisions such as depreciation recapture.

o Imposition of per-country requirements on the foreign tax credit limitation.

o Further skewing the tax system toward an income base, given the existing disparities between taxation of income and consumption.

NAM would support the following measures as part of an overall tax reform package:

o Retention of targeted incentives for investment, such as ACRS, the ITC or full CCRS with inflation indexation but no depreciation recapture.

o Indexation of inventory accounting

o Retention of preferential rates of taxation on capital gains.

o Cuts in corporate rates in order to even out the treatment of capital-intensive and non-capital intensive sectors.

o Simplification of individual tax brackets through the elimination of implicit subsidies (itemized deductions, etc.) affecting individuals rather than corporations.

o Mitigation of double taxation of dividends.

o The achievement of greater neutrality with respect to taxation of business and individuals.

o The achievement of greater neutrality with respect to taxation of income and consumption.

TABLE 5

RATIO OF U.S. TRADE TO PRODUCTION & CONSUMPTION: SELECTED MANUFACTURED GOODS CATEGORIES, 1972-1984

PRODUCT GROUP	EST. TOTAL 1984 U.S. SHIPMENTS	REAL AVG. ANNUAL GROWTH 1972-84	IMPORTS AS SHARE OF DOMESTIC CONSUMPTION			EXPORTS AS SHARE OF DOMESTIC PRODUCTION		
			1972	1981	1984	1972	1981	1984
A. HIGH TECHNOLOGY & ELECTRONIC PRODUCTS								
COMPUTERS	$50.0 Bil.	19.1%	4%	7%	19%	22%	28%	27%
SEMICONDUCTORS	17.7	34.7	15	34	39	20	35	32
INSTRUMENTS -								
- Eng. & Optical Instr.	7.9	9.0	10	19	16	12	36	26
- Measuring & Control Instr.	9.5	6.1	4	5	5	19	21	16
- Electricity Meas. Instr.	7.5	9.3	8	12	11	20	31	22
TELEPHONE EQUIPMENT	12.6	4.2	2	4	13	7	7	6
AEROSPACE -								
- Civilian Aircraft	8.0	-0.5	2	22	29	28	65	56
- Engines	10.2	0.3	6	14	17	19	20	30
- Other Aircraft Equip.	12.4	2.3	11	18	20	26	41	40
PHOTOGRAPHIC EQUIPMENTS	16.2	4.5	7	15	16	12	16	15
IND. INORGANIC CHEMICALS	12.2	2.1	10	21	21	18	25	21

TABLE 5

PRODUCT GROUP	EST. TOTAL 1984 U.S. SHIPMENTS	REAL AVG. ANNUAL GROWTH 1972-84	IMPORTS AS SHARE OF DOMESTIC CONSUMPTION			EXPORTS AS SHARE OF DOMESTIC PRODUCTION		
			1972	1981	1984	1972	1981	1984
B. SELECTED OTHER INDUSTRIES								
ELECTRICAL EQUIPMENT -								
- Transformers	$ 3.0 Bil.	-0.9%	3%	6%	10%	3%	8%	7%
- Motors & Generators	7.7	0.6	5	10	13	9	12	10
MACHINE TOOLS	3.9	-3.2	10	27	31	9	12	10
CONSTRUCTION MACHINERY	10.7	-3.4	2	9	12	28	41	20
FARM MACHINERY	10.5	0.1	10	13	17	11	23	22
OIL FIELD MACHINERY	7.1	6.2	1	4	1	45	42	40
GENERAL INDUSTRIAL MACHINERY -								
- Internal Combustion Eng.	9.2	0.1	6	6	5	16	24	21
- Compressors	2.8	4.4	8	9	12	28	32	26
- Pumps	5.8	2.1	4	9	7	16	18	16
MOTOR VEHICLES	114.0	2.6	8	19	16	2	5	2
(Passenger Cars Units	-	-	15	27	25	-	-	-)
STEEL MILL PRODUCTS*	43.0	-4.1	17	19	22	3	3	1
HOUSEHOLD APPLIANCES	15.6	1.6	7	9	13	4	10	7
RADIO & TV SETS	6.7	7.6	37	59	59	4	10	10
FOOTWEAR -								
- Leather Shoes	4.3	-3.6	17	33	51	0	2	2
- Rubber & Plastic Shoes	0.7	-2.1	34	48	37	0	4	3
TEXTILES & APPAREL -								
- Textile Mill Products	54.0	1.0	5	6	7	3	7	3
- Man-Made Fibers	9.6	3.9	5	6	7	4	6	3
- Apparel	57.3	1.2	7	12	20	1	2	2

* - Steel trade on tonnage basis
(Note 1984 numbers based on Commerce Department estimates of total shipments.)

SOURCE: HAM from data in Commerce Department U.S. Industrial Outlook, 1985 and unpublished data.

TABLE 6

U.S. MANUFACTURES TRADE - MAJOR PRODUCT CATEGORIES, 1980-1984

	U.S. EXPORTS			U.S. IMPORTS			BALANCE		
	1984 ($bil)	CHANGE fr '83 (%)	CHANGE fr '80 (%)	1984 ($BIL)	CHANGE fr '83 (%)	CHANGE fr '80 (%)	1984 ($bil)	CHANGE fr '83 ($bil)	CHANGE fr '80 ($bil)
TOTAL TRADE - Imports c.i.f.	217.9	9	-1	341.2	27	33	-123.3	-53.9	-86.9
Agricultural Products	37.8	4	-10	21.6	10	15	16.2	-1.8	-6.8
Manufactured Goods	143.1	8	-1	231.9	36	76	-88.8	-50.6	-101.3
Petroleum Products	4.5	-2	61	58.2	7	-24	-53.7	-3.9	20.4
TOTAL TRADE - Imports Customs Value	217.9	9	-1	325.8	26	33	-107.9	-50.4	-83.3
Agricultural Products	37.8	4	-10	19.8	20	14	18.0	-1.6	-5.9
Manufactured Goods	143.1	8	-1	221.5	35	77	-78.4	-47.4	-97.2
Petroleum Products	4.5	-2	61	55.9	7	-24	-51.4	-3.7	19.8
BY "END-USE" DEFINITION - Imports Customs Value									
Capital Goods	72.0	7	-1	59.8	46	102	12.2	-14.1	-30.8
Automotive Products	20.6	23	30	53.5	31	97	-32.9	-8.9	-21.7
Consumer Goods	13.3	-1	-18	60.0	34	74	-46.7	-15.2	-28.5
Industrial Supplies & Materials (Excluding Petroleum)	57.0	10	-16	66.4	24	27	-9.4	-7.7	-24.9
MANUFACTURED GOODS BY MAJOR SITC CATEGORIES - Imports Customs Value									
Chemicals (SITC 5)	22.4	13	8	13.7	27	59	8.7	-0.3	-3.4
Basic Manufactures (6)	15.1	1	-32	46.1	32	43	-31.0	-11.1	-21.1
--Paper	2.6	0	-7	5.6	33	56	-3.0	-1.4	-2.2
--Textiles	2.4	0	-33	4.5	41	80	-2.1	-1.3	-3.2
--Iron & Steel	1.3	-13	-58	10.9	60	46	-9.6	-3.8	-5.3
--Non-Ferrous Metals	1.6	0	-47	8.2	11	8	-6.6	-0.8	-2.0
Machinery & Transport Equipment (7)	90.0	9	6	119.2	38	97	-29.2	-26.2	-63.8
--Office Machines & Computers	14.6	25	68	10.8	59	272	3.8	-1.1	-2.0
--Electrical Machinery & Parts	13.8	16	31	18.3	46	126	-4.5	-3.9	-6.9
--Power Generating Machinery (Including Engines)	9.1	5	7	7.3	38	92	1.8	-1.6	-6.4
--Non-Consumer Telecommunications Equip.	3.9	0	11	8.5	42	136	-4.6	-2.5	-4.5
--Construction & Special Purpose Machinery	8.0	7	-16	5.6	51	73	2.4	-1.4	-3.8
--General Industrial Machinery & Parts	7.9	-1	-24	6.9	44	77	1.0	-2.2	-5.5
--Machine Tools	1.2	9	-33	2.0	33	11	-0.8	-0.4	-0.8
--Agricultural Machinery & Tractors	1.7	6	-45	1.5	25	7	0.2	-0.2	-1.5
Automotive & Transport Equipment									
--Cars	4.9	17	26	29.2	28	74	-24.3	-5.6	-11.4
--Automotive Parts	4.0	21	-34	8.8	40	76	-4.8	-1.8	-5.9
--Aircraft & Parts	10.9	-11	-15	3.0	50	58	7.9	-2.3	-3.0
Miscellaneous Manufactures (8)	15.7	3	-4	42.5	34	79	-26.8	-10.3	-18.4
--Professional, Scientific, & Controlling Instruments	6.2	5	17	2.7	53	93	3.5	-0.5	-0.4
--Clothing	0.8	0	-33	13.5	41	111	-12.7	-3.9	-7.5
--Toys, Games & Sporting Goods	0.7	-22	-30	3.3	32	74	-2.6	-1.0	-1.7

SOURCE: NAM, from Statistics in Commerce Department, HIGHLIGHTS OF U.S. EXPORT AND IMPORT TRADE

Chairman LAFALCE. We will now hear from Mr. Edward Bernstein, the Brookings Institution.

STATEMENT OF EDWARD M. BERNSTEIN, GUEST SCHOLAR, THE BROOKINGS INSTITUTION

Mr. BERNSTEIN. There are many provisions, as my colleague here has indicated, in the tax program that will affect U.S. trade and investment. I am going to consider only three of the most important provisions that affect U.S. trade. I think we have to start with the proposition any change in our tax law that affects corporations that compete in foreign markets for exports will affect its competitive position. We don't have to start with the question, are we more favored than, say, corporations in other countries? We can assume they aren't going to change anything, and if we change our tax law, it will have the effect of changing our present relative position.

The investment tax credit, which goes back more than 20 years, to the Kennedy administration, was originally designed to stimulate investments at a time when we felt we could not try to do it through a change in interest rates. We were having very great difficulty with our balance of payments, primarily because of the huge American investment abroad. We actually imposed the interest equalization tax to keep Americans from investing as much as they were then, and it wouldn't have been feasible to stimulate the domestic economy by lowering the interest rate. The investment tax credit, therefore, was a substitute for it.

In fact, the investment tax credit can be conceived of as having an interest rate equivalent. Let me show you what I mean. If a corporation gets a 10-percent investment tax credit, then instead of having to provide $100 for each $100 price of the equipment, it can do it with $90, and you can find out what the interest rate equivalent is by comparing what would be the yield on a bond priced at $90 for the relevant period, say 12 years, as compared with a bond issued at $100 with that same coupon.

I find at present that the termination of the investment tax credit would have the same effect on the increased investment costs, as a rise of 1⅝ to 1¾ percent in the interest rate. Now, this would, of course, keep American firms from investing as much as they otherwise would because, as I will indicate, they have to measure the gross investment return against the gross investment cost, and this is one, of the investment costs.

Much the same can be said for the change in depreciation rules. The change in the depreciation rules are not as radical in the revised program as they were in Treasury I, but they do nevertheless involve, so to speak, a less favorable depreciation system than the present one, at least in the first few years.

Now, you can do the same thing with the accelerated depreciation as with the investment tax credit. What happens when you have accelerated depreciation is that you recover the capital cost sooner. The average amount of capital invested in a piece of equipment is reduced to that extent, and you can get the equivalent interest rate effect of a change in the depreciation rules. Incidentally, in the 1960's, we also made depreciation rules more favorable and for much the same reason as the investment tax credit.

A long time ago I said that if we want to find out whether a given investment is desirable, profitable I should say, the right way is not to compare the profits, the net profit, with the interest cost but to compare the gross investment costs—that is to say, capital plus depreciation—as against the gross investment return, which is the cash flow. I figure that what we are doing here is, in fact, making investment more expensive, especially for American manufacturing firms, and particularly those that are heavily dependent on the use of capital equipment.

The argument has been made that this is less significant in a period of floating rates than under fixed rates. Under fixed rates, in fact, we can say that an increase in U.S. costs would be immediately, or with some modest delay, converted into a deterioration in our trade balance. The argument has been made, and we long believed it was true, that the adverse change in the price competitive position of the United States would be offset by a fall in the value of the dollar in a system of floating rates. This hasn't happened.

At present, according to the International Monetary Fund, the great rise of the dollar since 1980, has involved an average appreciation of roughly 80 percent against the currencies of the Group of 10 in Switzerland weighted by their exports. Incidentally, this is the method that is used by the Federal Reserve with some modifications.

Now if we take the period from the low point of the dollar, roughly the end of June 1980, and take it down to last Friday, we had an 80-percent appreciation of the dollar in the sense that you could get 80 percent more units of foreign currency per dollar now than you could then. It ranged from 120 percent more for some currencies, down to as little as 15 percent more for the Japanese yen. For the European currencies as a group, it was pretty much 100 percent appreciation of the dollar.

Chairman LaFalce. What is your timeframe there?

Mr. Bernstein. This is June 30, 1980, to last Friday, June 7, 1985.

There is a table that I have attached here showing—at the end of this paper—what it is for each currency separately. You see that for the five European Monetary System countries it averages 100 percent. If you add Canada, Japan, Sweden, Switzerland, and the United Kingdom, the average falls to 80 percent.

According to the International Monetary Fund, since 1980, the relative unit labor cost in manufacturing in the United States rose, so that it was 53 percent higher at the end of 1984, fourth quarter—than the average of 13 other countries, on a 1980 base. That is in unit labor costs.

The relative rise is a little bit less when you take into account other elements in cost. That is to say, other factor elements in cost. So that at the end of 1984, the relative value added, what we call the implicit price deflator in manufacturing, was 40 percent above the average for these other countries.

Now bear in mind that this comparison takes into account three things: It takes into account the rise in wages in local currency, the dollar exchange rate for the currency and the change in productivity or output per unit of labor. No matter how we look at it, American industry is very heavily penalized in its competition in world trade.

I don't think that what we are doing here is of major consequence in reducing the competitiveness of U.S. industry, but the hope that somehow the exchange rate will offset it is too optimistic. The exchange rate is now dominated by capital flows. Capital flows are roughly now three times as large relative to trade as they were, say, in the 1960's.

We are living in a world in which the movement of capital is easy, the floating of exchange rates makes it attractive in some countries, and in any case, world markets have become so unified that foreigners now want to establish firms in the United States and are putting very large sums in direct investment in this country. Actually direct investment of foreigners in this country in the last 5 years has been roughly—an average, say, of around $17 or $18 billion a year. It was as high as $21 billion last year, over $21 billion. It averaged $300 million a year in the 5 years from 1961 to 1965. It gives you some notion of how the whole world now wants to own a piece of the American economy. Very wise they are in wanting it.

Now there is one favorable point on the tax program I would like to make, and it is this: If we are reducing the marginal tax rate from 46 to 33 percent, it means that in fact a corporation which is planning investments and thinking in terms of after-tax, it can afford to have a reduction of one-fifth of its pretax profits and still wind up after-tax as well off as it was before.

I am not saying or arguing that even these adverse effects ought to be decisive in deciding on what our tax policy should be. It will be more equitable when we are through than it is now, and that is a matter of great consideration.

We can hope that at some stage, the exchange system will operate in a way that will offset changes that we make in national policy. It is clear, though, that up to now the hope that floating exchange rates will give countries greater freedom in fiscal and monetary policy is completely wrong. It just doesn't happen. You can't isolate yourself from the world.

But with a deficit of $107 billion in our trade balance last year and running at $116 billion a year in the first 4 months of this year, I would have thought that we would bear in mind as far as possible, without undermining the tax reform program, whether there are areas where it would be helpful to modify what is now being proposed. Ultimately, though, I think we have to depend on the International Monetary Fund to do a better job of getting international collaboration for a more orderly system of exchange rates.

The United States and other countries have more recently said they are willing to collaborate on that. The Fund has this authority. That is our real problem—the overvaluation of the dollar.

[The prepared statement of Edward M. Bernstein follows:]

Statement of Edward M. Bernstein
Guest Scholar, The Brookings Institution*
to the
Subcommittee on Stabilization
House Banking Committee
June 11, 1985

The program proposed by the President is designed to simplify the tax system, to make it more equitable, and to encourage the growth of the economy. Among other changes in the taxing of individuals, it would treat income from different sources more nearly equally, eliminate or reduce the benefits of most tax shelters, and establish three tax brackets in place of the 14 in the present law. In the taxation of business firms, among other changes, it would eliminate the tax preferences that some industries now have, repeal the investment tax credit, replace the present accelerated depreciation with a capital cost recovery system reflecting the useful lives of the capital assets, and reduce the basic tax rate on corporate profits from 46 per cent to 33 per cent.

Such far-reaching changes in the tax system are certain to affect the evolving industrial pattern of the economy. Some of the proposed changes will particularly affect U.S. companies engaged in world trade-- in competing with the exports of other industrial countries in foreign markets and in competing with imports from these countries in the domestic market. The greatest effect will come from the repeal of the investment tax credit and the replacement of the present depreciation rules. That is not because the tax program would discriminate against countries competing in world trade. Rather, it is because these companies are the principal beneficiaries of the investment tax credit and accelerated depreciation. Our export- and import-competing industries are engaged in goods production and they use more capital equipment than companies in most service industries.

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* The views in this statement are those of Mr. Bernstein and should not be attributed to the Brookings Institution, its trustees, officers or staff.

Differences in tax provisions in this country and in other industrial countries, or changes in such provisions, affect their competitive position in world trade and the structure of their balance of payments. That was very important under a system of fixed par values, such as the one established at Bretton Woods. Lower taxes on producers in Europe or Japan made it more difficult for U.S. companies to compete with their companies in world export markets and in the domestic markets of the United States and those other countries. In the 1960s, for example, the United States argued that the rebate of the Value Added Tax on exports of the European countries and the imposition of the Value Added Tax on their imports from the United States were discriminatory. Nevertheless, this was permitted under the General Agreement on Trade and Tariffs. The United States, on the other hand, depended more on income and profits taxes, and the GATT rules did not allow the rebate of such taxes to U.S. exporters or the imposition of comparable taxes on U.S. imports. This was one reason why the United States authorized U.S. exporters to form Domestic International Sales Corporations whose profits were not taxable until remitted to this country. Other countries protested that this was a subsidy on U.S. exports. The legislation has been repealed because it is not needed under a system of floating rates.

With fixed par values, a rise in prices and costs in the United States, not matched by a change in other industrial countries, resulted in a decrease in U.S. exports and an increase in U.S. imports. Under a system of floating rates, it was assumed that a change in prices and costs in U.S. manufacturing industries would be offset by a compensating change in rates of exchange for the dollar. Thus, the adverse effect on U.S. trade of a rise in costs would be offset by a fall in the foreign exchange value of the dollar so that the price competitive position would be unchanged, The international payments of the United States would be in balance, with a surplus in the current account appropriate to the structure of the U.S. economy matched by a net capital outflow to finance U.S. foreign investment. If the system of floating rates really worked like this, the United States would not have to be particularly concerned with the effect that changes in its tax system would have on the balance of payments.

It is obvious, however, that the system of floating rates has not worked in this way, particularly in the past five years. From the end of June 1980 to June 7, 1985, the foreign exchange value of the dollar has risen by an average of about 80 per cent in terms of the currencies of the other countries in the Group of Ten and Switzerland, weighted by their exports in 1977-79. Such a change in the foreign exchange value of the dollar cannot be due to changes in the rate of inflation-- that is, differences in the rise of prices and costs. Rather, it is due to the enormous inflow of foreign capital. The importance of capital flows in the balance of payments has increased enormously in the past three decades. In 1951-55, U.S. private capital outflow was equal to 15 per cent of our merchandise exports. This ratio rose to 25 per cent in 1961-65 and 31 per cent in 1971-75. In the past five years, the reported average annual outflow of U.S. capital was $67 billion, the reported inflow of foreign capital other than official funds was $75 billion a year, and the statistical discrepancy, which is mainly a net inflow of capital, averaged $24 billion a year. This was equal to 34 per cent of merchandise trade. It is the major reason why the system of floating rates has not worked in the expected manner-- to maintain an appropriate pattern of international payments in a world in which there are large differences in the behavior of prices and costs in the industrial countries and great changes in their reciprocal demand for exports and imports.

It is likely, although by no means certain, that the increase in production costs in U.S. manufacturing industries as a result of the tax program will not be fully offset by a decline in the foreign exchange value of the dollar.

That is not to deny, of course, that the dollar may fall for other reasons, such as a change in capital flows. If there were no domestic factors offsetting the rise in production costs that would result from the changes proposed in the tax program, the price competitive position of the United States in world trade would be impaired. In fact, however, the fall in interest rates in the past year is more than equivalent to the elimination of the investment tax credit and the replacement of accelerated depreciation.*

The investment tax credit has the effect of reducing the capital costs of investment in eligible equipment. Instead of borrowing 100 per cent of the cost of the equipment, a firm can finance the investment by borrowing only 90 per cent of the cost. It is possible, therefore, to determine what reduction in interest rates would have the same effect on financing investment as the tax credit. If the credit is 10 per cent on equipment with a useful life of 12 years, then the interest rate equivalent is the difference between the yield on a bond issued at par and one with the same coupon priced at 90. Thus, a 12-year bond with a coupon of 11 per cent selling at 90 would yield 12.6 per cent to maturity. The investment tax credit at recent interest rates, therefore, was equivalent to a reduction of about 1.6 per cent in the interest rate on a 12-year loan. Actually, the yield on high grade corporate bonds of 12-year maturity has fallen by about 3 per cent in the past year.

Much the same analysis can be made for determining the interest rate equivalence of accelerated depreciation. The usual method of determining the profitability of investment is to compare the net return with the interest cost. In a paper on the factors affecting investment which I published many years ago, I argued that it is the gross annual investment return, the cash flow, that must be compared with the gross annual investment cost, interest plus depreciation, to determine the attractiveness of investment in equipment.* For one thing, the estimate of actual depreciation, including obsolescence, is at best approximate and at worst arbitrary. Moreover, the gross annual investment cost emphasizes not only the interest on the capital but the recovery of the cost of the equipment through the depreciation allowances. When the tax regulations allow accelerated cost recovery, the average amount of capital invested in the equipment over its useful life is reduced, and the resulting saving is equivalent to a reduction in the interest rate on the capital that would have to be invested if the recovery of costs were spread evenly over the useful life of the equipment.

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* My analysis of the interest rate equivalence of an investment tax credit and accelerated depreciation was noted by Harry G. Johnson in an article on "International Monetary Issues" in the Federal Reserve Bulletin, May 1964, p. 1408.

The reduction in the maximum tax rate on corporate profits is another partial offset to the increase in costs that would result from the elimination of the investment tax credit and the change in the depreciation rules. There are differences of opinion as to whether the tax on corporate profits is shifted to ultimate absorbers of corporate output. Probably over time, a significant increase or decrease in the tax rate of corporate profits would be shifted in part through a change in the prices of output. If that is so, the reduction in the basic tax rate from 46 per cent to 33 per cent will offset some of the increase in costs or the reduction in profits resulting from the other changes in the proposed tax program. For a corporation paying a tax of 46 per cent on its profits, a reduction to a rate of 33 per cent would offset a decline of 20 per cent in the profits from a marginal investment attributable to the absorption of the increased cost resulting from the elimination of the investment tax credit and the replacement of accelerated depreciation with the proposed capital cost recovery system.

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* E. M. Bernstein, "Wage-Rates, Investment and Employment, Journal of Political Economy, April 1939, pp. 218-31.

Many American industries are hard pressed to compete with manufacturers in other countries in world markets, in their domestic markets, and above all in U.S. market. The main reason for this is the overvaluation of the dollar based on relative prices and costs in the large industrial countries. This difficulty has been aggravated by the emergence of new foreign suppliers whose exports are mainly directed to the United States. The magnitude of the problem is shown by the trade deficit of $107 billion in 1984 and at an annual rate of about $116 billion in the first four months of this year. This problem cannot be dealt with by offering subsidies to U.S. exports and imposing penalties on U.S. imports. The only remedy that will be of benefit to the United States and the world economy is the restoration of a pattern of exchange rates that reflects the relative international position of the large industrial countries. This can be done only by the collaboration of the United States and other members with the International Monetary Fund which has the responsibility for surveillance of the exchange rate policies of its members and the functioning of the present system of floating exchange rates.

FOREIGN EXCHANGE VALUE OF THE DOLLAR, 1980 AND 1985

	Foreign units per dollar		
	June 7 1985	June 30 1980	Per cent increase 1980 to 1985
European Monetary System			
Belgium	62.010	28.120	120.6
France	9.3950	4.0870	129.9
Germany	3.0820	1.7582	75.3
Italy	1960.0	838.70	133.7
Netherlands	3.4725	1.9275	80.2
Other Group of Ten			
Canada	1.3720	1.1510	19.2
Japan	249.60	217.60	14.7
Sweden	9.8900	4.1503	114.2
Switzerland	2.5955	1.6185	60.4
United Kingdom*	1.2720	2.3620	85.7
Average of five currencies in EMS#			102.2
Average of ten currencies in G-10#			80.3

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* Dollars per pound sterling.

# Weighted by each country's global exports in 1977-79.

BIOGRAPHICAL SKETCH

Name:	Edward M. Bernstein, born December 16, 1904, Bayonne, N.J.; married, three children
Education:	University of Chicago, Ph.B., 1927; Phi Beta Kappa Harvard University, A.M., 1928; Ph.D, 1931; Ricardo Prize, 1928; University Fellow in Economics, 1928-29
Employment:	North Carolina State University, Associate Professor of Economics, 1930-35 University of North Carolina, Associate Professor of Economics, 1935-37; Professor of Economics, 1937-40 Harvard University, Visiting Professor of Economics, Summer 1957 U.S. Treasury Department, principal economist, 1940-41; Assistant Director of Monetary Research, 1941-46; Assistant to the Secretary of the Treasury, 1946 International Monetary Fund, Director of Research, 1946-58 E M B (Ltd.), Research Economists, President, 1958-81 Brookings Institution, Guest Scholar, Economic Studies Program, 1982-
Boards:	Advisory Council, Department of Economics and Sociology, Princeton University, 1955-58 Director, Lease Financing Corporation, 1969-71 Director, Aetna Variable Life Insurance Company, 1971-74 Director, Washington Institute of Foreign Affairs, 1974- Visiting Committee, Division of Social Sciences, University of Chicago, 1980- Council of the Harvard Graduate Society, member, 1980- ; chairman, 1981-82 Visiting Committee, Department of Romance Languages, Harvard University, 1981- Brookings Council, 1983-
U.S. Missions:	Chief Technical Adviser and Executive Secretary, U.S. Delegation, Bretton Woods Monetary and Financial Conference, 1944 Delegate, International Telecommunications Conference, Bermuda, 1945 Chief Economist, President Truman's Economic Survey Mission to the Philippines, 1950 Staff Director, Public Advisory Board for Mutual Security, Report on a Trade and Tariff Policy in the National Interest, 1953 Chairman, Review Committee for Balance of Payments Statistics, 1964-65 Member, Advisory Committee on International Monetary Arrangements, U.S. Treasury, 1965-68 (Dillon Committee) Member, Advisory Committee on Presentation of the Balance of Payments, Office of Management and Budget, 1975-76
Awards:	Order of the Southern Cross, Brazil, 1961 Distinguished Service Award, U.S. Treasury, 1968 Doctor of Laws (honorary), University of North Carolina, 1977 Professional Achievement Award, University of Chicago Alumni, 1979

Chairman LaFalce. Mr. Bernstein, you are proceeding under the assumption one of the primary justifications for dealing with the changes in the Tax Code was the thought that the floating exchange rate system would balance it, but I don't know if that entered into the thought process of those who advocated so-called tax reform at all.

Mr. Bernstein. I don't think so. I didn't suggest that it did. I think, in fact, the general assumption up until now——

Chairman LaFalce. I thought you were setting that up as an argument and knocking it down.

Mr. Bernstein. What I am saying is we have long assumed that the exchange rate will leave the price competitive position of a country unchanged, even if it had a larger rise in prices and costs than its competitors, the reason being whatever we lose in higher costs will be offset by depreciation of currency. I mean it was that assumption which led us to make various changes at various times. For example, that was a big argument for giving up the Domestic International Sales Corp. You don't need it any more when you have floating rates.

What I am arguing now is that the floating rate system hasn't worked that well, and we must assume, therefore, if we increase the costs of American producers, they will in fact have a deterioration in their price competitive position not fully offset by the exchange rate. There may be some change in the exchange rate to partially offset it.

I am not arguing that changes in the Tax Code should be made mainly on the basis of the international economic position of the United States or its effect on our trade. I don't think we can ignore the situation in the United States today where one-fourth of the economy is actually in depression, and that includes farming, though I attribute that to the bad working of the exchange system. I am not suggesting this should be the decisive element in any consideration of the tax program.

Chairman LaFalce. Is the exchange system working so badly or is it just reacting to the fiscal monetary conditions that are existent primarily in the United States?

Mr. Bernstein. No, it isn't reacting——

Chairman LaFalce. Is it just a bad consequence of bad fiscal and monetary policies?

Mr. Bernstein. It is the bad working of the exchange system and the other element enters into it too. Let me show what I mean by bad working.

Chairman LaFalce. As a corollary ~~to~~ that——

Mr. Bernstein. I think it needs some qualification. It is a very favored argument that the budget deficit is the cause of the large appreciation of the dollar. If you go back to the days when we started with this system in 1973, and I favored it by the way, I didn't think we ought to have had the second devaluation of the dollar because I didn't think it would work—the one in February, 1973.

Now, beginning in 1973, going on to 1979, we had a fall in the dollar against the Deutsche mark that ranged up to 25 percent over a period of 3 to 6 months, and then we would have it recover again over much the same period. We had about three or four such changes, and I discussed this in a paper published by the American Enterprise Institute for a program sponsored by the Treasury and the American Enterprise Institute.

You can't speak of a system in which you have a 25-percent rise and fall in the dollar in periods of a few months as working well. Underlying economic conditions don't change so rapidly, and when they do change, they aren't reversed so quickly. So it isn't working in the sense that we had intended originally—that changes in the exchange rate will reflect changes in underlying economic conditions and leave the price competitive position in world trade virtually unchanged.

Now we come back to the question whether the present rise of the dollar by roughly 80 percent against these leading currencies from 1980 to the present is due to (a) high interest rates in the United States and (b) whether high interest rates are due to the fiscal policy of the United States.

First let's use some simple logic. Interest rates now are lower in the United States than they were in 1980. It doesn't make sense to me to say that a German businessman, banker or investor will pay 75 percent more in Deutsche marks to earn 2 or 3 percent more per annum in dollars for a few years.

Chairman LAFALCE. Let me interrupt you so I can understand a little better what you are saying. Are you talking about nominal interest rates or real interest rates—when you say today that is one thing, because the rates have come down rather precipitously in the last few months——

Mr. BERNSTEIN. So why haven't they——

Chairman LAFALCE. The point is, we are dealing with a phenomenon that has taken place from 1978 to 1980 to the present, and are your statements relevant to just today or during that period?

Mr. BERNSTEIN. They are relevant to the whole——

Chairman LAFALCE. Weren't the real interest rates of the United States considerably higher than any place else in the world?

Mr. BERNSTEIN. I will come to that in a moment. Businessmen don't think in terms of real interest rates.

Chairman LAFALCE. They don't?

Mr. BERNSTEIN. No. I will tell you how they think. They ask themselves the question, what is the interest rate nominally, and what is the prospect of a change in the exchange rate? It is the change in the exchange rate plus the interest rate that concerns them. It isn't the real interest rate. They aren't thinking in those terms, and they have no reason to think in those terms.

A German doesn't have to think in terms of whether the real interest rate is higher in the United States than elsewhere. He is not going to be in the United States; he is going to be in Germany. What he wants to know is if he buys dollars, earns 3 or 4 percent more for a few years, and then goes back to Deutsche marks, will he be better off or not? And that means the change in the exchange rate more than the difference in interest rates.

I am going to quote a business man who spoke to me a year ago about this question. His name is Jack Bennett—he used to be Under Secretary of the Treasury for Monetary Affairs. He said to me, "Is it really necessary that a rise in the interest rate should bring a rise at all in the exchange rate? And if so, why?"

He said we do agree there has to be a relationship between spot and forward exchange rates based on interest rate differentials. My answer was there is good reason to think a rise in interest rates will bring a rise in the exchange rate, but not a very big one.

Let me ask you this question, and I want to get to the real interest rate concept. Suppose real interest rates, meaning the interest rate adjusted for changes in relative prices in the United States and Germany, were 4 percent higher in the United States than in Germany. A German bringing money into the United States has to ask himself this question—although the real interest rate is 4 percent higher, won't it be offset by a depreciation of the dollar. He has to ask himself: How long will this difference in interest rates last? If it is only going to last 1 year, then it pays me to pay 4 percent more for the dollars than before but expect the dollar to begin to decline so that when the Federal Reserve changes the interest rate next year, the dollar will be back to the rate determined by relative prices and costs—that is, inflation.

If he expects it to last 4 years, he would be willing to pay 16 percent more for dollars, but the dollar has actually risen by 75 percent. So I am going to give you what I think is the real explanation. The real explanation is that the whole world wants to own a piece of the United States. That is shown in a variety of ways. In 1984, it was $21 billion for direct investment. In 1 year——

Chairman LAFALCE. Is this in your statement?

Mr. BERNSTEIN. No, it is not in my statement. I will give you this table, though, if you want it.

Chairman LAFALCE. Please.

Mr. BERNSTEIN. In 1 year, about 2 years ago——

Chairman LAFALCE. What do you define as direct investment?

Mr. BERNSTEIN. Direct investment means there is acquisition of plant and equipment in the United States, including real estate, real assets, operating assets, not common stocks unless that gives control. But it doesn't mean a foreigner has to own all of it. If associated foreigners own 10 or 20 percent of the stock of an American company, it is considered direct investment. This is the actual money the foreigners use to acquire the direct investment. The value of the assets may be much more than $21 billion because there have been liabilities along with the assets they acquired.

About 4 years ago, in 1981, the takeover of American businesses and the establishment of new businesses in the United States by foreigners involved companies with assets of $100 billion. It gives you some notion of what is going on.

With the rest of the world in recession, except in Japan, and the American market so big, every company abroad feels if they could get into the American market and do well, have they really made it. This is the big league. Here is where it counts, if you want to make very big businesses. This is a major element in the strength of the dollar.

In 1980–84, foreigners were net purchasers of $20 billion of American common stocks, although they were net sellers of $600 million last year. Even when they buy bonds, they are much more concerned with the future exchange value of the dollar than with high interest rates.

We come down to the part where interest rates should be most effective, and that is liquid funds put into the money market in the United States. Well, enormous sums were brought in, enormous sums went out, both incoming and outgoing were exaggerated by a statistical anomaly, and that was the creation of the international banking facilities in the United States. The transfer of funds to the United States from offshore branches involved equal assets and the liabilities, and as both were moved simultaneously, they had no net effect. It just blew up the amounts that were involved.

Let me tell you what happened to the flow of banking funds between the United States and the rest of the world. First, until about 2 year ago, the outflow of banking funds from the United States was greater than the inflow. That is to say, if we take the reported changes in the assets and liabilities of American banks, in 1980–82, our banks lent about $120 billion more abroad than foreigners brought into the United States. The change that occurred in 1983–84, when foreigners brought in $44 billion more than our banks lent abroad, was primarily because American banks stopped lending to Latin America. Much of the money that came into the United States from foreign branches of U.S. banks and from foreign offices to the U.S. offices of foreign banks was often brought in to engage in covered interest arbitrage. They weren't buying dollars as such, they were buying dollars spot and selling them forward in order to earn slight differences in interest rates which were due to the failure of the market to adjust the spot and forward rates to the changes in interest rates.

Now I want to get to another element. When people keep telling me that the rise of the dollar is all due to interest rates I ask this question: Does it make no difference as to the composition of the capital inflow? Does it make no difference what people want to buy, our plant and equipment, common stocks, long-term bonds? Is that as much affected by interest rates as the liquid funds that move in and out. And do we make no allowance for the fact that the international environment has changed?

Chairman LaFalce. What percentage are liquid funds of the whole?

Mr. Bernstein. Those are very variable, the liquid funds. Last year the inflow of liquid funds reported by banks the difference between their liabilities to foreigners at the end of 1983 and again in 1984 was $27.6 billion. Claims reported by U.S. banks, lending by U.S. banks to foreigners, increased by only $7 billion in 1984.

But, as I indicated, the big change in the relation of incoming funds was when we stopped lending to Latin America.

Chairman LaFalce. Of the total investment in the United States, how much is in liquid funds; what percentage?

Mr. Bernstein. Are you including official funds too, or just——

Chairman LaFalce. I am trying to find out what you are talking about, to try to get some handle and measurement on it, and you are saying, oh, not much is liquid funds. I am, therefore, asking you how much is in liquid funds? What are you talking about, what percentage of the whole?

Mr. **Bernstein**. Are you talking about the flow in, say, 1984, or are you talking about the accumulation over the whole history——

Chairman **LaFalce**. I am not talking about anything, I am trying to find out what you are talking about.

Mr. **Bernstein**. I am trying to find out what you are asking me.

Chairman **LaFalce**. Give me both.

Mr. **Bernstein**. We have what is called the international investment position of the United States, which will show how the foreign assets of the United States and the assets of foreigners in this country are distributed; how much is in direct investment, securities, bank claims, and so on. That is the accumulation over the whole history insofar as we know it. The balance of payments shows what changed last year.

All right, last year $93 billion came into the United States from abroad as reported—$27 billion of that was reported by banks, that is coming to them. The rest was in securities, direct investment and claims on nonbank concerns. In addition $3 billion of official funds came to the United States.

Now, I wanted to add funds that came here but were not reported. Last year we had an excess of $30 billion of unreported receipts over unreported payments. This $30 billion is generally regarded as being unreported capital inflow. It is money coming in from, say, South America that went to Miami or some other place, maybe to buy a condominium, or to put money in securities, or to hold in deposits under a domestic address. If it is a domestic address, it doesn't get reported as a foreign investment.

If a foreigner has a brother-in-law whose address he uses for his security transactions or bank transactions, it won't get into the balance of payments accounts as reported foreign capital inflow. Instead it will get caught up in errors and omissions. Now, that $30 billion probably came in more for safe haven reasons than for higher interest rates.

So, I would say that the attempt to link the big flows of foreign capital primarily to interest rates is mistaken. I think the whole world wants to buy up dollar assets in the United States, and they are very wise to do it. It is really the counterpart of what we were doing in the 1960's. We were buying assets in Europe and the outflow of funds from the United States was enormous.

Chairman **LaFalce**. Very well, Professor. This has become more a consideration of the exchange rate system than it has of the tax plan and its specific impact on international competitiveness. I have allowed you to go on because we are considering it. I find it so interesting and intriguing.

Professor Bernstein, Mr. Jasinowski has said many economists disagree rather strongly with him, at least as they did in some panel recently, and we have heard from many economists, too, and some would give one reason more so than another. A good number would say it is the safe haven nature of the U.S. economy, and a great many others would say it is the high real interest rates, and some would say it is a composite of them, and it is hard to ascribe any percentage of the total to any one portion.

Do you have any comments that you would like to make on that before we continue?

Mr. **Jasinowski.** Yes, Mr. Chairman; and I appreciate your asking me. In general, I would associate myself with Professor Bernstein's views, and I think that he has—even though it is a bit complicated to follow for I am sure some of the audience—has presented I think a very important point which has not gotten enough attention in discussion about exchange rates. I think in the process of doing that, he has gone a bit too far in terms of downplaying the effect of interest rates.

If you just listen to the capital flow numbers he gave you, it is pretty clear that a very large portion of the capital flow is for short-term instruments that are not direct investments in American industry. Rather this money is here for differences in yields. I think he is quite right, businessmen don't look at real interest rates, but, in fact, real interest rate differentials are an economist's way of explaining the short-term capital flows; these short-term flows, from figures he has given and my own analysis of this issue, are at least as significant as the direct investment. But I rather like his presentation, because I think it puts a point of emphasis——

Chairman **LaFalce.** You rather like his presentation because whether you agree with it or not, it buttresses your arguments.

Mr. **Jasinowski.** Not at all. It doesn't buttress my argument. Quite the contrary. Our argument, from a narrow parochial point of view, would be it is a largely deficit and interest rate question.

Chairman **LaFalce.** I mean your argument on not changing the Tax Code with respect to investment tax credit, et cetera.

Mr. **Jasinowski.** It doesn't have much to do with it. We are really talking about a different subject here, although everything affects international competitiveness, I am intrigued because although people talk about the safe haven argument, they haven't put it as cleverly as he has, and he has backed it up with numbers and the fact of the matter is direct investment is going up, the composition of international financial closings are important.

My own discussion with foreign businessmen led me to believe they want a piece of the action. For all those reasons I think he has done a service. I do think he has understated in the process these capital flows for short-term reasons, but my final conclusion would be it is both factors, therefore, reducing the deficit, bringing down American interest rates are important.

But it would be a mistake to think we are going to go through a period of a low dollar if we pass this package which is now going on between the Senate and the House. There are still going to be these considerations, and we are going to be back a year from now talking about——

Chairman **LaFalce.** We are going to allow one brief comment, and then we will go to Mr. Fullerton.

Mr. **Bernstein.** I want to read you some interest rates. This is from the International Monetary Fund. In 1980, the average of money market funds in the United States was 13.36 percent. In April 1985, it was 8.27 percent. That is to say it is down over 5 percent.

Chairman **LaFalce.** That is nominal.

Mr. **Bernstein.** That is right. The differences that we are talking about ought to be changes in the differences in interest rates. In the case of the Netherlands, it is down from 10.13 to 6.76 percent. To put it another way, the differential has been narrowed between the United States and the Netherlands over this 5-year period.

Chairman LAFALCE. What was the difference in the real—is it relevant to just give nominal, Professor?

Mr. BERNSTEIN. It is relevant. Shall I tell you why?

Chairman LAFALCE. Why not. It seems to me you can't give accurate statistics unless you are comparing real and real.

Mr. BERNSTEIN. Mr. Chairman, the rate of inflation in the United States in the last 3 or 4 years hasn't been much different from what it was in the Netherlands. Changes in the nominal and real interest rates were much the same in the United States and the Netherlands, between 1980 and 1985.

Chairman LAFALCE. If you think that is an important statement, you are saying the real and the nominal rates are fairly closely aligned, but we don't know that. That is why we need to know what the inflation is in different countries as well.

Mr. Fullerton.

STATEMENT OF DON FULLERTON, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA

Mr. FULLERTON. Let me apologize for being late. I am sorry. I just got off the plane. And I should apologize for having missed some of the earlier discussion. I am not sure what I will be repeating of what has been said before or whose remarks I may be walking over.

Chairman LAFALCE. I think yours will be considerably different from Mr. Jasinowski and Mr. Bernstein. You may assume you are speaking freshly.

Mr. FULLERTON. OK. I also have a written statement here.

I am pleased to be invited to testify. I take it the topic is the taxation of income from capital in the United States and other industrialized countries. I am particularly honored to be asked back after only a few months since my last testimony.

First, I would like to tell you about the project involving nine researchers over 5 years. It was designed to measure strictly comparable tax rates in the United States, the United Kingdom, Sweden, and Germany, and then I would like to convey some of what I learned on my trips in the past 2 weeks to Japan and Canada.

Major efforts are underway in both of those countries to establish marginal effective tax rates that are strictly comparable to the results of this earlier study. In this book, "The Taxation of Income from Capital, A Comparative Study of the United States, United Kingdom, Sweden and Germany," edited by Mervin King and myself, we undertook to develop a single consistent methodology that could be used in any country to measure investment offered by the combination of a long list of features, including Federal corporate taxes, investment tax credits, interest deductions, State corporate taxes, Federal and State personal income tax, Federal and State property taxes.

The average effective tax rate can be said to measure the amount of these taxes actually paid divided by some measure of capital income. And it has been claimed to approach 70 percent in the United States, once you add together the corporate taxes paid plus property taxes paid plus personal taxes on interest and dividends.

In contrast, the marginal effective tax rate we measured is the total expected future tax on a new investment as a measure of expected future income from it, and this rate may be a better measure.

In contrast to the 70 percent number just mentioned, the overall rate we get in the United States is about 37 percent. This overall average of tax rates on new investment masks a very wide distribution, however. The attached figure at the back of the testimony showing four countries in the lower right panel shows the United States where marginal effective tax rates can exceed 100 percent on equity financed investment and structures or inventories. They receive no dividend deduction. That is the typical double taxation story of corporate and personal taxes adding to each other in a way that the total tax can exceed 100-percent of the income from assets.

At the other extreme, 100-percent subsidy can be received by a firm investing in new equipment receiving 10 percent investment tax credits, accelerated allowances, particularly if they finance the allowances and deduct the nominal interest payments. These effective tax rates include all of the taxes paid, and so we trace through and add in the tax on the interest received by individuals.

But there may be no subsequent personal tax if the interest is received by tax-exempt institutions, such as a pension fund. So this 100-percent subsidy, oddly enough, means that the asset is really not productive at all, it is not earning anything, but the entire normal return to the investor is provided by the Government in the form of these investment tax credits and other tax offsets. Those are the two extremes. The figure shows the distributional rates with a peak of about 30 percent of corporate capital being taxed at rates in that bar between 80 and 90 percent and another total of about 30 percent is tax rates below. That is subsidized.

So much for the United States. The other panels in this—first of all, the United Kingdom in 1980 had the widest distribution of different tax rates, ranging from a 300 percent subsidy to a 120 percent tax. The United Kingdom allowed immediate expensing of machinery even if it was debt financed, so the firm could write off the asset, take interest deductions and get regional grants, et cetera.

Sweden has a fairly wide distribution, but Germany has the most narrow distribution of the four. One interesting result of the study is that the list of countries ranked by overall growth ranks was the same as those—that is, Germany had the fastest growth rate and the most uniform tax system, followed by Sweden, the United States, and Britain was last with the slowest growth rate and widest distribution of different tax rates. That is an interesting observation. I don't mean to claim anything about causation, but it does tend to indicate a more neutral tax system might be a good indicator for overall growth.

In fact, it was partly in reaction to this sort of result that Britain decided to eliminate the immediate expensing of new machinery. It was those benefits, together with the other grants, that caused the huge subsidies shown in the figure. Enough of those results.

In the past 2 weeks I have been with the American Enterprise Institute to Japan and just flew in from Canada, had discussions with economists at the Ministries of Finance at both those countries, and there are projects underway in those two countries, I am happy to say, to measure marginal effective tax rates using the exact methodology we used in this book. So we will soon have a fully comparable set of estimates for six countries, but I have seen some of the preliminary results for those two, which indicate, first of all, for Canada that rates are very similar to the United States, that they vary less than in the United States. In fact, they vary less than in Germany.

It should be noted that the distribution of different effective tax rates in Canada is even more concentrated than the distribution of rates in Germany, and their growth rate over the same period was higher than that in Germany, so it maintains the ranking that I just discussed.

The reason that Canada has a very tight distribution of effective tax rates is that they have a lower statutory corporate rate, lower investment tax credits, and a reduction of the double tax on dividends. You might observe that that combination of features sounds a lot like the recent Treasury and White House proposals, lower tax rates and some percentage dividend deduction.

Also, in Canada, the debt financed investment does not receive such a huge subsidy like in the other countries because the 38 percent overall rate, including Federal taxes and Provincial taxes at which corporations deduct nominal interest, is close to the rate of interest individuals are taxed on normal receipts.

One of the stories in the United States is corporations are deducting nominal interest at a combined Federal and State statutory rate of more than 46 percent, about a 49.5-percent rate, and that interest recipients are including that nominal interest at only about a 23-percent rate so that any increase in inflation which pushes up nominal interest rates increases that subsidy to debt-financed investments. That subsidy is a lot less in Canada where those rates are a lot closer together, but the deductions are taking place at the same rate the interest is being taxed.

Japan is a different story, but not because of any special credits, deduction or investment incentives. It is very similar to the system in the United States except that they allow no investment tax credit and no fast depreciation writeoffs. Much has been made of the low cost of capital in Japan. I think it is clear from what I have seen in the past few weeks that an investment in Japan would pay a higher effective tax rate than an equity financed investment in the United States.

Even though the tax rules are very similar, corporations in Japan can deduct nominal interest payments at a rate of about 55 percent, while individual interest recipients are taxed at personal rates that are very low. Each household can have up to 3 tax-free accounts. There is a special savings account, a government savings account and other things, each with three million yen or $12,000, so that each household can have a combined savings of $36,000 that are not subject to taxes on interest income, and moreover the enforcement is very difficult because these accounts can be at different banks or institutions, and it is easy to open up more than the allowed three accounts.

A major difference between Japan and the United States is not the tax rules but individual practices.

Chairman **LaFalce**. I just want to stop you for a second, Professor, and point something out. You say it is not the tax rules. As a matter of fact, Japan doesn't have an accelerated tax rate and depreciation, et cetera. A good number of individuals have complained it is the overvalued dollar that accounts for so much of our trade deficit with Japan.

In looking over the statistics Professor Bernstein has given us, we see although the percent increase in the dollar was 14 percent, that paled in comparison to the overall average of the five currencies in the European monetary system, 102 percent, and paled in comparison to the average of 10 currencies used, which was 80 percent. In fact, an increase in the value of the dollar vis-a-vis the yen was the smallest of any of our major trading partners in the entire world.

So you might add a major difference between the United States and Japan is not the tax rules, but the institutional practices.

Mr. **Fullerton**. That may be.

Mr. **Bernstein**. I would like to add a point to this. The major difference, I think is institutional, but I think you would be interested in this figure. The major difference between Japan and all other industrialized countries is the fact that wages in Japan in manufacturing have risen less than the increase in productivity. I am reading from a press release of December 31, 1984, comparison of these same 14 countries we were talking about before. Japan is the only country in which unit labor costs have fallen in the past 10 years in its currency.

Chairman **LaFalce**. Why don't we come back to that.

Mr. **Bernstein**. I have it right now if you are interested.

Chairman **LaFalce**. I am, but I don't know that we should take time on that issue. Professor Fullerton.

Mr. **Fullerton**. The reason that I want to say a little bit about the institutional practices is because it drives the difference in the measures of effective tax rates. While I think these tax rules are qualitatively similar in Japan and the United States in the sense that debt is treated very similarly in Japan and the United States, and equity is treated similarly in Japan in the United States, Japanese firms are somehow able to use a significantly higher fraction of their subsidized debt finance. The ratio of debt to total capital is about one-third in the United States and nearly a half in Japan.

The result is that when we sort of average together the effective tax rates on the equity financed stuff that are high in both countries and the effective tax rate on the debt financed stuff that are subsidized in both countries, when Japan gets a higher wait on the debt, their overall effective tax rate is much lower.

So why or how are these Japanese firms able to use so much debt? That was the most frequent question that I asked of the researchers in Japan last week, and from a number of different sources I received two types of answers. First, Japanese firms are able to have a very close working relationship with a particular bank. They do not shop around for the best interest rates when they want to borrow, and instead do each deal with only one bank. That bank knows a lot about the business of the firm. It is an ongoing relationship that can be rather intimate. The bank may even own stock in the firm.

Second, securities markets were not very well developed in Japan during the period after the war so that the rapid economic expansion did not have access to new equity and, therefore, necessarily financed more by debt. This is simply the story I heard there. But as the wheels of the Japanese stock market have been greased, equity has gradually replaced much of that debt. The debt ratio is falling in Japan.

While it is still nearly a half, it is falling toward that of the United States. Congress cannot exactly legislate these institutional practices, and I think it would be a mistake to try to make the United States more like Japan by increasing the subsidy to debt financed investment. Such a change would only widen the distribution of already diverse effective tax rates in the United States.

The single most important change that I think would make the U.S. tax system more like Japan's tax system would be the elimination of investment tax credits. Corporate tax provides 30 percent of national level revenue in Japan and only 10 percent of Federal revenue in the United States. This change of eliminating investment tax credits would also decrease the disparity in taxes on different assets that are shown in the attached figures.

Finally, I note a sometimes paranoid reaction of U.S. business to what they view as the lower cost of capital in Japan and is matched sometimes only by the paranoid reaction business-related researchers I talked to in Japan. Their government is under constant pressure to enact issues like those in the United States in order to be competitive with the United States, but the Finance Minister there views those ineffective in terms of promoting new investment.

Thank you.

[The prepared statement of Don Fullerton follows:]

Testimony
of Don Fullerton
Associate Professor of Economics, University of Virginia
Visiting Scholar, The American Enterprise Institute

before the
House Banking Committee
Subcomittee on Economic Stabilization

June 11, 1985

Mr. Chairman and members of the subcommittee, I am very pleased to be invited to testify on the taxation of income from capital in the U.S. and other industrialized countries. I am particularly honored to be invited back only a few months since my last testimony before this subcommittee.

In the brief time allowed, I would like first to tell you about a project involving nine researchers over five years, to design and measure strictly comparable marginal effective tax rates in the U.S., U.K., Sweden, and West Germany. Second, I would like to convey some of what I learned on my trips in the past two weeks to Japan and Canada. Major efforts are underway in both of those countries to measure marginal effective tax rates that are also strictly comparable to the results of the original four-country study.

In The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden, and West Germany, edited by Mervyn King and myself, we undertook to develop a single consistent methodology that could be used in any country to measure the investment incentives offered by the combination of federal corporate taxes, depreciation allowances, investment tax credits, interest deductions, state corporate taxes, federal and state personal income taxes, and state and local property taxes. The "average" effective tax rate measures the amount of these taxes actually paid, as a fraction of capital income. It has been measured to approach 70 per cent overall in the United States. The "marginal" effective tax rate, however, measures the total expected future tax on a new investment, as a fraction of the expected future income from it. This rate might be a better measure of the incentives to make new investment, but the overall rate in the United States is only about 37 per cent.

This overall rate masks a very wide distribution, however. The attached figure shows the United States in the lower right panel, where marginal effective tax rates can exceed 100 per cent on equity-financed investments in structures or inventories that receive no investment tax credit, no dividend deduction, less accelerated depreciation allowances, and full personal taxation of dividend receipts.

At the other extreme, a 100 per cent subsidy can be received by a firm investing in new equipment, receiving a 10 per cent credit and accelerated allowances, financing the investment by issuing debt, and deducting the interest paid. There may be no subsequent personal tax if the interest is received by a tax-exempt institution such as a pension fund. The 100 per cent subsidy means that the asset itself is not productive at all, but the entire normal return to the investor is provided by the government. The figure shows the distribution of rates, with almost 30 per cent of corporate capital taxed at rates between 80 and 90 per cent, and another 30 per cent taxed at rates below zero.

The other panels in this figure show that the U.K. in 1980 had the widest distribution of tax rates, ranging from a 300 per cent subsidy to a 120 per cent tax. Sweden also has a fairly wide distribution, but Germany has the most narrow distribution of the four. One interesting result of this study was that the list of countries ranked by overall growth rates was exactly the same as the list of countries ranked by the uniformity of their effective tax rates. Germany has had the fastest growth rate and the most uniform tax system, followed by Sweden and the U.S. Britain has the slowest growth and the widest distribution of different effective tax rates.

In fact, it was partly in reaction to this sort of result that Britain decided to eliminate the immediate expensing of new machinery. These benefits together with interest deductions and other investment grants caused the huge subsidies shown in the figure.

Enough of old results. In the past two weeks, I have had discussions with economists at the Ministries of Finance and other research institutions in Japan and in Canada. Projects are underway for each of those two countries to measure marginal effective tax rates using the exact same methodology. Preliminary results suggest that the Canadian rates are very similar to those in the U.S., but they vary less than in the United States because Canada has a lower statutory corporate rate, lower investment tax credit, and a reduction of the double tax on dividends. Debt-financed investment does not receive a huge subsidy like in other countries, because the 38 per cent overall rate at which corporations deduct nominal interest is close to the overall marginal rate of individuals who are taxed on nominal interest receipts.

Japan is a different story, but not because of any special credits, deductions, or other investment incentives. In fact, the corporate tax system in Japan is very similar to the system in the United States, except that they allow no investment tax credit and no fast depreciation write-offs. Much has been made of the low cost-of-capital in Japan, but I think it is clear from what I have seen that an equity-financed investment in Japan would pay a higher effective tax in Japan than in the United States.

Debt-financed investments might receive a slightly greater subsidy in Japan than in the United States. Even though the tax rules are very similar, corporations in Japan can deduct nominal interest payments at a combined national and sub-national statutory rate of about 55 per cent, while individual interest recipients are taxed at personal rates that are very low. Each household can have up to three tax-free accounts, each with 3 million yen ($12,000).

The major difference between Japan and the U.S. is not the tax rules, but the institutional practices. Even though debt and equity are each taxed similarly in the two countries, Japanese firms are somehow able to use a significantly higher fraction of the subsidized debt finance. The ratio of debt to total capital is about one-third in the U.S., and nearly one-half in Japan.

Why or how are Japanese firms able to use so much more debt? From a number of different sources, I received two types of reply. First, Japanese firms tend to have a very close working relationship with a particular bank. They do not shop around for the best interest rates whenever they want to borrow. Instead they each deal with only one bank, and that bank knows a lot about the business of the firm. The bank may even own stock in the firm.

Second, securities markets were not very well developed in Japan during the period after the War. The rapid economic expansion did not have access to new equity, and was therefore necessarily financed proportionately more by debt. As the wheels of the Japanese stock market have been greased, however, equity has gradually replaced much of that debt. The falling debt/equity ratio in Japan may, in fact, reach that of the U.S.

Congress cannot exactly legislate these institutional practices, and I think it would be a mistake to try to make the U.S. more like Japan by increasing the subsidy to debt-financed investment. Such a change would only widen the distribution of already diverse effective tax rates. The single most important change that would make the U.S. tax system more like Japan's tax system would be the elimination of investment tax credits. The corporate tax provides 30 per cent of national-level revenue in Japan, and only 10 per cent of federal revenue in the U.S. This change would also decrease the disparities in taxes on different assets.

Finally, I note that the almost paranoid reaction of U.S. businesses to what they view as the lower cost of capital in Japan is matched only by the almost paranoid reaction of business-related researchers I talked to in Japan, to what they view as the lower cost of capital in the U.S. Their government is under constant pressure to enact investment incentives like those in the U.S., but the Finance Ministry views those incentives as costly in terms of revenue and ineffective in terms of promoting new investment.

Arigato (thank you).

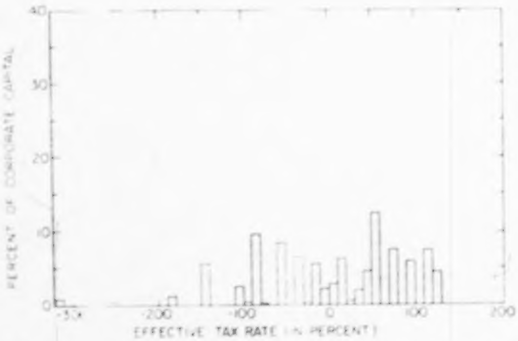


Fig. 7.6 Proportion of investment taxed at each rate in the fixed-p case for the United Kingdom

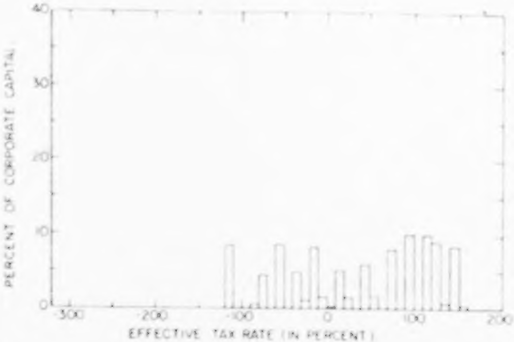


Fig. 7.7 Proportion of investment taxed at each rate in the fixed-p case for Sweden

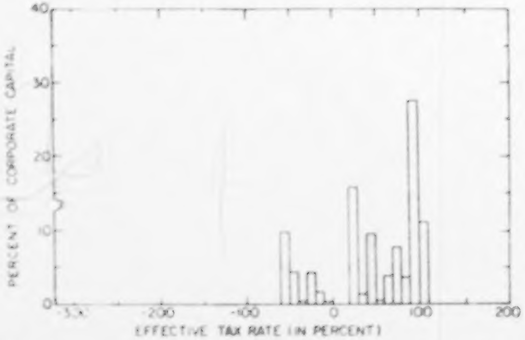


Fig. 7.8 Proportion of investment taxed at each rate in the fixed-p case for West Germany

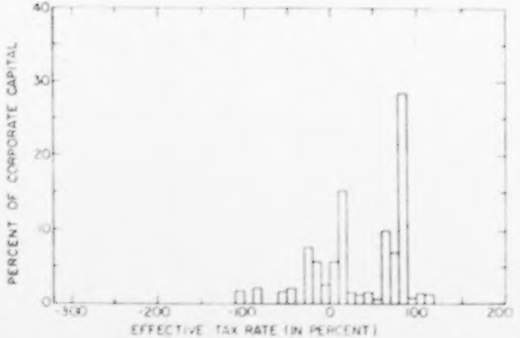


Fig. 7.9 Proportion of investment taxed at each rate in the fixed-p case for the United States

From Mervyn A. King and Don Fullerton (eds.) The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden, and West Germany, Chicago: The University of Chicago Press (1984).

Chairman LaFalce. Professor Fullerton, you recently did a study on the Treasury I plan and its impact on international competitiveness, did you not?

Mr. Fullerton. Effect on investment incentives. That did not have an international aspect particularly.

Chairman LaFalce. Do you have some judgments about either Treasury II or President Reagan's—how he wants to describe it and its effect on investment incentives?

Mr. Fullerton. Yes. I devised the computer programs for that study and the framework for the paper in such a way it would be easy to incorporate the White House proposal, once it came out. In fact, just looking at Treasury I, as I was working on it, I could see various components that were under discussion being dropped from the new proposal, so there is at least one table in that paper that shows the effect of each of the components of Treasury I so that you or I or President Reagan could pick or choose among those components to get a new package.

The interest indexing feature that was in Treasury I would have removed these subsidies to debt finance that I described here, and that has been removed by the White House proposal. First, we will still be able to deduct nominal interest, and individuals will still be taxed on nominal interest, but at a lower rate.

Another component is the RCRS. Of course, that is very similar in the new proposal, but slightly more accelerated. The largest component actually was the repeal of the investment tax credit; the largest, that is, in terms of the effect on these measures of marginal effective tax rates. It still raises the repeal of the investment tax credit by itself and makes the taxation of different assets much more uniform.

Repeal of the investment tax credit has the largest kind of effects in several ways of raising effective tax rates and leveling them. The equipment is no longer subsidized but treated as structures, which would remove a lot of incentives to misallocate capital and use inefficient production processes with too much equipment.

The other components of the Treasury plan, such as the taxation of only real capital gains at ordinary rates, did not have much effect in that study because those two things offset each other. That is, the indexing was actually worth slightly more than the exclusion in the way the numbers in my study came out, so that it is not clear that businesses, in an overall sense, gained anything by having convinced President Reagan to remove that indexing figure together with putting back in the exclusion.

I am sure that some firms did because, for example, small startup businesses are going to be a lot more interested in the capital gain exclusion since their gains are going to be a lot more than inflation, but other older industries might be more interested in the inflation indexes that were lost.

Let's see, the other component, the 50-percent dividend deduction, has been cut to a 10-percent dividend deduction. That wasn't a very big effect, in my numbers anyway.

Let's see, what—well, those are about the only components that I looked at that affect the income from capital and incentives to invest. Many of the others were not looked at in this study.

Chairman LaFalce. What about the recapture provisions?

Mr. **Fullerton**. I haven't looked at those in enough detail to say anything.

Chairman **LaFalce**. Mr. Jasinowski, could you make specific comment on the recapture provisions?

Mr. **Jasinowski**. Mr. Chairman, I will do that and try to relate it somewhat to what Mr. Fullerton was saying.

First of all, I think his testimony——

Chairman **LaFalce**. As I understand the recapture provisions, it is not only prospective, it is retroactive to whatever ACRS has taken already. Is that correct?

Mr. **Jasinowski**. Yes, that is correct. I think his emphasis on searching for more uniform rates in the American tax system and his emphasis on effective marginal rates is very important. Part of the reason the President's proposal has considerable value is because it decreases the number of subsidies and the disparity among rates. The reason I am much more critical than he is about the cost of capital is because of the very sharp increase in the short run by outright repeal of the investment tax credit and the recapture provision, which has a double hit on a very small segment of industry.

In the long run—and as Keynes said, "We are all dead in the long run"—the Treasury system looks pretty good. In the short run, my fear, and the recapturing provision is a big part of that, is that we are going to greatly reduce cash flow, which is just as important as marginal rates, and we are going to have capital cost increases in those sectors.

Now, finally, with respect to the recapture, I would say only this. It clearly was added at the last minute as an afterthought seeking to get additional revenues. It has not been thought out as tax policy. It reflects, I think——

Chairman **LaFalce**. If you want to recapture, why did they change the ACRS in the first place?

Mr. **Jasinowski**. They did change the ACRS, they made it CCRS, which is not so bad, but by reducing the rates, there was an argument one could make that we ought to recapture the revenues lost through accelerated depreciation.

The other side of it, you could say you made the rules up once, you ought to not go back and be retroactive. The short-term effect is a very massive increase on a very small segment of American industries. I think it is a serious mistake for that reason plus the fact it is an afterthought with no tax justification.

Chairman **LaFalce**. Let me just go down the line and make sure I understand where you come out after all the arguments for and against. If you had to vote—not Treasury I now, but on President Reagan I and your chief concern was for economic growth, would you vote yes or no?

Mr. **Fullerton**. Yes.

Chairman **LaFalce**. Mr. Jasinowski?

Mr. **Jasinowski**. I don't like the choice, but I would vote no.

Chairman **LaFalce**. Mr. Bernstein?

Mr. **Bernstein**. I vote yes.

Chairman **LaFalce**. Professor Bernstein, I am afraid that while I was having so much intellectual pleasure listening to you that I was relating most of what you said to international competitiveness in American industries in general. I didn't catch as much as I should have of what you said, leaving the relationship of what you said with respect to President Reagan's tax plan I. So obviously, since you favor the President's plan, your arguments critical of the floating exchange rate system we have were arguments advanced primarily to point out the necessity of dealing with that problem, and that is much more important when considering international competitiveness.

You didn't mean to suggest it as an argument against adoption of this plan?

Mr. **Bernstein**. No. It is really an answer to those who say it doesn't matter what you do on taxes because it will be absorbed by the exchange rate. It does matter. On the other hand, there is no substitute through anything you can do on taxes for the disorder in the exchange system.

Chairman **LaFalce**. Now, Mr. Bernstein, and Mr. Fullerton, can you address yourselves specifically to Mr. Jasinowski's problem that you can't deal simply in the aggregate, you must look at the disproportional impact this plan may have on different industries. He is, therefore, especially interested in that aspect of our economy. Professor Bernstein, you have concern for this. You pointed out one-fourth or so of American industry is in depression right now, or was it one-fifth that you said?

Mr. **Bernstein**. I said a fourth, but it doesn't matter. One-fifth may be more nearly accurate.

I have two answers to that question. Remember we were talking about what it costs an American firm to invest. We have had a drop of more than 3 percent in the yield on 12-year bonds from a year ago. A year ago we had a fall of interest rates about as much as we are taking—maybe a bit more—as we are taking away through the repeal of the investment tax credit and the change in the depreciation rules. So investment cost—interest plus depreciation—would be about the same as a year ago for most equipment.

The other point I made was that even if businesses had to absorb the increased costs so that profits went down, the reduction in the tax rate on profits from 46 to 33 percent would leave an after-tax return as much as before, even if there were a 20-percent drop in the pretax return on an investment.

Those are the two arguments that I have used to say this isn't going to be disastrous. The provision on investment isn't going to be any worse than it was a year ago.

Chairman **LaFalce**. Would any other person like to make any comments?

Mr. **Fullerton**. There are two kinds of answers I would make to that question as well. First of all, I don't doubt that business members of the National Association of Manufacturers would be made worse off by this plan. While that may well bother them, there are two reasons it might still be good policy. One is that odd incentives have been built into the current tax system, which benefit those who make heavy use of those incentives, such as the investment tax credit, in such a way they would lose with the removal of those odd incentives.

I said "odd" because it is not clear why the Government should know more about businesses, as to what form they should take for their investment or why equipment should be any more efficient than structures—there is no reason the government should know more about what combination of assets to use in production and to give them an incentive to use a particular combination of assets. So, with removing that kind of distortion, some groups are bound to gain and others lose, so there will be distributional implications to the tax planner if it is considered good policy.

The other kind of comment is related to the difference between the marginal investment incentives and the cash flow that was mentioned.

I also don't doubt if businesses were given more money as a gift, just a handover as cash, they would use some of it to invest. But I don't think that that is necessarily a very efficient way to get them to invest more. It might be more efficient to try to tilt them at the margin than to sort of push them into a little more investment in such ways as reducing the statutory rate, making more efficient investment by not subsidizing one kind of investment over another. That is to say, we are talking about the difference between income effect and price effect.

The recapture provision is probably a decent way to make up some revenue while treating those assets that were put in place under our ACRS exactly the same way they were expected to be treated when they were put into place under ACRS with this lifetime, with this 46-percent rate, et cetera. So, my impression of the recapture provisions is that they are trying to keep those old assets on the old schedules with the other rates or to approximate that, and a reduction of the rate from 46 percent to 33 percent on the income of those old assets would be like a cash gift to the firms without necessarily providing any incentive at the margin to make new investment except for the fact they are given cash and have the cash to spend.

Mr. **Jasinowski**. Mr. Chairman, let me reply to my colleagues on the policy merits. Obviously, I can't disassociate myself with the NAM so no matter what I say will be viewed as representing them, as it should. But let me just reply to the policy merits since they both commented.

I think this is a pretty good plan, and it would not have a disastrous effect, and nothing in my remarks should connotate disaster.

First, it is nevertheless in the part I have indicated bad policy for three reasons that my colleagues really haven't addressed. First of all, it does make a difference what kind of assets we encourage in this country, and there are substantial research that capital is a more productive asset in many cases in the form of equipment than either structures or inventories. We can debate that, but the whole notion that the degree of risk is the same for all assets and there is no difference in the degree of risk and, therefore, no difference in the degree of importance with respect to assets is a mistake, and beyond that, there are a lot of reasons why capital as an asset has substantial merit, and capital embodied in equipment has substantial technological and other merits which are very large.

Second, it has always been my understanding it is bad tax policy to make abrupt changes on the dime with respect to where you are going. I wouldn't argue against Mr. Fullerton's objective, to get a more uniform tax rate over some period of time, but it is not good policy to on the dime drop the investment tax credit and to put in a recapture provisions, and I would like to hear his arguments as to how it is good policy to do things abruptly and change the rules abruptly.

Third, flowing from the second, we are in a situation where we are likely to reduce the rate of capital spending in this country beyond what it is now in the short run—I am not arguing about the long-term merits of this plan—that could put us closer to a recession, which is not a good thing from a policy point of view. I would submit those three arguments are at least as significant as what my colleagues have argued and suggest they are issues that have to be addressed as well.

Chairman LaFalce. Yes.

Mr. Bernstein. On the recession argument, I think we ought to be a little careful. Assuming that in truth this is a revenue neutral tax program, it means what is gained——

Chairman LaFalce. You may assume it, but let's not assume it in truth.

Mr. Bernstein. Let's assume it for analysis. I agree with you. We have to be careful what it is in the end.

Let us assume it is revenue neutral. What the individuals are gaining in reduced taxes the corporations are losing in increased taxes. What the individuals gain they will, therefore, use to increase their spending. That is to say, their real disposable income will increase, and they will spend more. If the aggregate is really neutral, then I don't see any reason why we should think it will lead to a recession.

In fact, we could say, if final demand of consumers goes up, even though the investment cost is higher, the need for investment will also go up——

Chairman LaFalce. Except that the demand might be satisfied with foreign goods.

Mr. Bernstein. That is right, I don't think we can assume it is any more going to be satisfied with foreign goods than it would be if we invested in plant and equipment, because you must bear in mind about 25 percent of the investment in producers' equipment now is imported. In fact, there is no category of imports, with the exception of automotive products from Canada that has increased as much as capital goods. So, a very large part of the investment going on right now is putting into place of machinery and equipment coming from abroad.

Chairman LaFalce. Mr. Fullerton, did you have a comment you wanted to make?

Mr. Fullerton. I was thinking more about what Mr. Jasinowski said about the productivity of different assets, like equipment. I guess I wouldn't doubt the studies that show that equipment is more productive than other assets.

My question really involves whether or how the government could know more about that than the businesses do. If they really are productive, businesses would realize that and not need encouragement of a particular asset from government.

Chairman LaFalce. You are making the argument, in saying the investment tax credit——

Mr. Fullerton. I may have more faith than Mr. Jasinowski in American business. I think they are very good in——

Mr. **Jasinowski**. Again, it is a distinction between the short run and long run. I have no questions about the long run. My point, Mr. Chairman, is the short run.

Chairman **LaFalce**. If Charls Walker were here, he would argue you ought not to take away a tax subsidy because other countries are giving, if not tax subsidies, direct subsidies to their industries, and we don't give as many direct subsidies to our industries and, therefore, would be at a competitive disadvantage for that reason.

Mr. **Fullerton**. You would be amazed how many of the researchers at Kanounon Research Institute in Tokyo made the same argument about the United States. There were all kinds of unfair tax and other direct benefits to U.S. firms that gave them an unfair competitive advantage vis-a-vis Japanese firms and that the Japanese Government ought to do all this, that and the other thing to encourage their exports in order to be able to compete with U.S. firms.

Mr. **Bernstein**. May I make a comment on this question of more or less productive investment? I gather Mr. Fullerton was ready to agree there may be greater productive investment or more profitable in one field or another. Actually, at the margin, all net returns from investment allowing for risks, are presumed to be the same.

The arguments then for having investment in plant and equipment are that there are side benefits. That is to say if it has an effect of increasing output, it will manifest itself in part in sharing the increased output with the wager earner. And you can't say that for, say, a residential structure. It is a question of the effect of the investment on the rest of the community, the benefits the rest of the community get from the investment.

Chairman **LaFalce**. We let you have the last word. I want to thank the three panelists for their interesting and stimulating discussion of an important issue. I don't know that we have answered the questions. We have certainly discussed them in great detail. Thank you very much.

[Whereupon, at 11:40 a.m., the subcommittee was adjourned subject to the call of the Chair.]

IMPACT OF TAX SIMPLIFICATION ON VENTURE CAPITAL

WEDNESDAY, JUNE 19, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce.

Chairman LaFalce. Today's hearing is the eighth in a series of hearings our subcommittee has held on the sectoral consequences of tax reform.

This hearing will focus on perhaps the most dramatic change made in the revised tax proposal announced by President Reagan 3 weeks ago from the original Treasury plan released last November—the treatment of capital gains and its consequences for venture capital investment.

Under current law, capital gains are taxed at a preferential maximum rate of 20 percent. The Treasury proposal released last November would have indexed capital gains to inflation, but would have taxed them as ordinary income.

The revised tax proposal announced by President Reagan would tax capital gains at a top effective rate of 17.5 percent, even lower than under current law.

The principal economic justification for preferential treatment of capital gains is that it is a necessary incentive for venture capital investment. Without preferential treatment of capital gains, it is argued, investors would be much more reluctant to invest in new, high-risk enterprises. It is feared they might shift to more conservative investments.

Others contend that this is an exaggerated argument. They point out that venture capital gains are a small percentage of all capital gains, and that it is extraordinarily inefficient to give preferential treatment to all capital gains for the purpose of providing an incentive for venture capital investment.

In addition, they point out that the evidence is not clear that preferential treatment of capital gains has much influence on venture capital investment. A recent study in the monthly publication "Politics and Markets" found that only 15 percent of the total committed to venture capital in 1984 came from individual investors subject to the capital gains tax.

Forty percent came from investors exempt from the tax, such as pension funds, endowments and foundations. Foreign sources, which don't have to pay American taxes, and corporations such as insurance companies, which have low effective tax rates, were responsible for the remaining 45 percent.

What is not in dispute is that preferential treatment of capital gains disproportionately benefits the wealthy. According to the Joint Committee on Taxation, taxpayers with incomes over $50,000 reap over 80 percent of savings from low capital gains tax rates, and those with over $200,000 receive over 40 percent of those savings.

Here to address these issues this morning is an exceptionally expert panel of witnesses: Mr. Charles E. McLure, Jr., Deputy Assistant Secretary of the Treasury for Tax Analysis; Don E. Ackerman, chairman, committee on tax policy, National Venture Capital Association; Joseph Minarik, senior research associate, the Urban Institute.

Gentlemen, it is indeed a pleasure to have you with us today. We will put the entire text of your remarks into the record, and we would ask that each of you try to give your presentation in no more than a 10-minute period.

We will first call upon Mr. McLure.

STATEMENT OF CHARLES E. McLURE, Jr., DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, DEPARTMENT OF THE TREASURY

Mr. McLure. Mr. Chairman, I am pleased to be here to discuss the capital gains provisions of the President's tax proposals to the Congress for fairness, growth and simplicity.

I would like to present a prepared statement which describes the proposed changes and discusses them briefly, and then I will be glad to answer your questions.

Proposed changes: The major change in the individual tax treatment of capital gains proposed by the administration is a reduction in the exclusion rate on nondepreciable assets from 60 percent to 50 percent.

Coupled with the proposed reduction in individual rates, this will result in a reduction in the maximum individual tax rate on long-term capital gains from 20 percent to 17.5 percent. The administration also proposes that preferential, capital gain treatment no longer be accorded to depreciable property used in a trade or business.

However, depreciable assets placed in service prior to January 1, 1986, would not be subject to the new rule.

The administration proposes no changes in the limitation on the deductibility of capital losses against an individual's ordinary income, which would remain at $3,000 per year, with unlimited carry-forward permitted.

The current provisions which allow rollover of gain on certain sales of principal residences and a $125,000 exclusion on housing gains for taxpayers 55 years of age or older would be retained.

Also, the holding period for long-term capital gains would be left unchanged at 6 months, and the corporate tax rate on capital gains would be left unchanged at 28 percent.

Finally, the administration proposes that, beginning in 1991, individual taxpayers could elect to index the basis of their capital assets for inflation occurring after January 1, 1991, rather than take the proposed 50-percent exclusion. This election would be effective for all capital gains recognized by a taxpayer in a particular year.

Discussion of the proposed changes: The proposed treatment of capital gains on nondepreciable assets realized between July 1, 1986, and December 31, 1990, is roughly similar to that under current law, but slightly more generous. Thus, the proposal is conceptually different from the original Treasury proposal to index the basis of capital assets for inflation and then tax real capital gains at ordinary income rates.

The primary difference between the two approaches is that an exclusion or a "preferential rate" applied to nominal capital gains provides an approximate adjustment for the fact that the inflationary component of a nominal capital gain is inappropriately subject to tax; with indexing, the inflationary component of the gain is simply removed from the tax base.

The relative tax burden on a given real gain under the two approaches varies in a complex way which depends on inflation rates, real rates of appreciation, and holding periods.

In general, the administration proposal will be more generous than indexing for low rates of inflation, high real rates of appreciation, and long holding periods.

The original Treasury proposal to tax real capital gains at ordinary income rates reflected a desire to introduce an explicit adjustment for inflation and to achieve the reduction in complexity associated with eliminating preferential treatment of a particular type of income.

These concerns were viewed as outweighing the concern that the elimination of the exclusion might have adverse effects on innovation, investment, capital formation and growth.

However, many individuals and businesses expressed a strong concern that we underestimated the negative effects of our initial proposal, especially with respect to high-risk investments by individual entrepreneurs and venture capitalists.

Moreover, several individuals have suggested to us that the complexity and potential for abuse with indexing might be sufficiently great to outweigh the simplicity benefits obtained from taxing real capital gains as ordinary income.

The proposed 50-percent exclusion provides a way to continue incentives for entrepreneurship, risk-taking and investment, as well as an ad hoc adjustment for inflation, while the delay of indexing until 1991 provides us with more time to evaluate various criticisms of indexing.

The administration proposal is likely to have a more positive effect than the original proposal on the supply of venture capital to new and emerging firms. Successful venture capital investments have very high rates of real appreciation, and thus will be treated more generously under a 50-percent exclusion than they would have been under the original Treasury proposal.

Venture capitalists tell us that the capital gains tax reductions in 1978 and 1981 were critical to the dramatic increases in the supply of venture capital in recent years. The further reductions proposed by the administration should stimulate further increases in the supply of venture capital, which will be of particular benefit to the new and emerging firms which are among the most dynamic and innovative elements of our economy.

Similarly, the proposed 50-percent exclusion should encourage investment by individual entrepreneurs who forego stable sources of income and start high-risk enterprises on the expectation that the return will be higher than average.

The effect on more traditional investments is difficult to predict. Historically, investors would have fared better in the 1970's and early 1980's under an indexing scheme than with the current exclusion.

However, since inflation has subsided in recent years, indexing is less critical now than it was in the recent past. Moreover, representatives from the securities industry insist that individuals invest only if they have the expectation that their investment will earn above-average real returns.

To the extent such investors are concerned primarily with the tax treatment of highly successful investments, they will view the 50-percent exclusion as more generous than indexing and thus be more likely to supply funds to equity markets. Such increased investment would stimulate capital formation and economic growth.

Another benefit of the reduced capital gains tax rates proposed by the administration is that the so-called lock-in effect will be reduced. Under current law, taxpayers do not pay tax on accrued capital gains until they are realized, and can avoid tax completely when gains are transferred at death.

Thus, the taxation of gains results in an impediment to sales of assets with accrued gains. Rate reductions reduce this impediment, and thus increase realizations.

Treasury revenue estimates suggest that the increased realizations induced by the rate cut are sufficiently large that the rate reduction has little or no net effect on capital gains tax revenues over the 1986–90 period.

Finally, under current law, depreciation deductions are taken against ordinary income and losses on depreciable property are treated as ordinary losses. Under the proposal, such property will benefit from depreciation allowances which are both accelerated relative to economic depreciation and indexed for inflation.

For such assets, the administration believes that further preferential treatment would be inappropriate, and that the benefits of accelerated and indexed depreciation allowances will be sufficiently large that the elimination of preferential capital gains treatment will not have a significant negative effect on investment.

Moreover, the elimination of capital gains treatment on depreciable assets will eventually eliminate the need for the highly complex recapture rules of current law.

This concludes my prepared remarks. I will be happy to answer your questions.

[The prepared statement of Charles E. McLure, Jr., follows:]

STATEMENT OF
CHARLES E. McLURE, JR.
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE BANKING SUBCOMMITTEE ON
ECONOMIC STABILIZATION

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss the capital gains provisions of The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity. I would like to present a prepared statement which describes the proposed changes and discusses them briefly, and then I will be glad to answer your questions.

Proposed Changes

The major change in the tax treatment of capital gains proposed by the Administration is a reduction in the exclusion rate on nondepreciable assets from 60 percent to 50 percent. Coupled with the proposed reduction in individual rates, this will result in a reduction in the maximum individual tax rate on long-term capital gains from 20 percent to 17.5 percent. The Administration also proposes that preferential capital gain treatment no longer be accorded to depreciable property used in a trade or business. However, note that depreciable assets placed in service prior to January 1, 1986 would not be subject to the new rule.

The Administration proposes no changes in the limitation on the deductibility of capital losses against an individual's ordinary income, which would remain at $3,000 per year (with carry forward permitted). The current provisions which allow rollover of gain on certain sales of principal residences and a $125,000 exclusion on housing gains for taxpayers 55 years of age or older would be retained. Also, the holding period for long term capital gains would be left unchanged at six months, and the corporate tax rate on capital gains would be left unchanged at 28 percent.

Finally, the Administration proposes that, beginning in 1991, individual taxpayers could elect to index the basis of their capital assets for inflation occurring after January 1, 1991, rather than take the proposed 50 percent exclusion. This election would be effective for all capital gains recognized by a taxpayer in a particular year.

Discussion of the Proposed Changes

The proposed treatment of capital gains on nondepreciable assets realized between July 1, 1986 and December 31, 1990 is roughly similar, although slightly more generous, than under current law. Thus, the proposal is conceptually different from the original Treasury proposal to index the basis of capital assets for inflation and then tax real capital gains at ordinary income rates.

The primary difference between the two approaches is that an exclusion or a "preferential rate" applied to nominal capital gains provides an approximate adjustment for the fact that the inflationary component of a nominal capital gain is inappropriately subject to tax; with indexing, the inflationary component of the gain is simply removed from the tax base. The relative tax burden on a given real gain under the two approaches varies in a complex way which depends on inflation rates, real rates of appreciation, and holding periods. In general, the Administration proposal will be more generous than indexing for low rates of inflation, high real rates of appreciation, and long holding periods.

The original Treasury proposal to tax real capital gains at ordinary income rates reflected a desire to introduce an explicit adjustment for inflation and to achieve the reduction in complexity associated with eliminating preferential treatment of a particular type of income. These concerns were viewed as outweighing the concern that the elimination of the exclusion might have adverse effects on innovation, investment, capital formation, and growth.

However, many individuals and businesses expressed a strong concern that we underestimated the negative effects of our initial proposal, especially with respect to high risk investments by individual entrepreneurs and venture capitalists. Moreover, several individuals have suggested to us that the complexity and potential for abuse with indexing might be sufficiently great to outweigh the simplicity benefits obtained from taxing real capital gains as ordinary income. The proposed 50 percent exclusion provides a way to continue incentives for entrepreneurship, risk-taking, and investment, while the delay of indexing until 1991 provides us with more time to evaluate various criticisms of indexing.

The Administration proposal is likely to have a more positive effect than the original proposal on the supply of venture capital to new and emerging firms. Successful venture capital investments have very high rates of real appreciation, and thus will be treated more generously under a 50 percent exclusion than they would have been under the original Treasury proposal. Venture capitalists tell us that the capital gains tax reductions in 1978 and 1981 were critical to the dramatic increases in the supply of venture capital in recent years. The further reductions proposed by the Administration should stimulate further increases in the supply of venture capital, which will be of particular benefit to the new and emerging firms which are among the most dynamic and innovative elements of our economy. Similarly, the proposed 50 percent exclusion should encourage investment by individual entrepreneurs who forego stable sources of income and start high risk enterprises on the expectation that the return will be higher than average.

The effect on more traditional investments is difficult to predict. Historically, investors would have fared better in the 1970s and early 1980s under an indexing scheme than with the current exclusion. However, since inflation has subsided in recent years, indexing is less critical now than it was in the recent past. Moreover, representatives from the securities industry insist that individuals invest only if they have the expectation that their investment will earn above-average real returns. To the extent such investors are concerned primarily with the tax treatment of highly successful investments, they will view the 50 percent exclusion as more generous than indexing and thus be more likely to supply funds to equity markets. Such increased investment would stimulate capital formation and economic growth.

Another benefit of the reduced capital gains tax rates proposed by the Administration is that the so-called "lock-in" effect will be reduced. Under current law, taxpayers do not pay tax on accrued capital gains until they are realized, and can avoid tax completely when gains are transferred at death. Thus, the taxation of gains results in an impediment to sales of assets with accrued gains. Rate reductions reduce this impediment, and thus increase realizations. Treasury revenue estimates suggest that the increased realizations induced by the rate cut are sufficiently large that the rate reduction has little or no net effect on capital gains tax revenues over the 1986-1990 period.

Finally, under current law, depreciation deductions are taken against ordinary income and losses on depreciable property are treated as ordinary losses. Under the proposal, such property will benefit from depreciation allowances which are both accelerated relative to economic depreciation and indexed for inflation. For such assets, the Administration believes that further preferential treatment would be inappropriate, and that the benefits of accelerated and indexed depreciation allowances will be sufficiently large that the elimination of preferential capital gains treatment will not have a significant negative effect on investment. Moreover, the elimination of capital gains treatment on depreciable assets will eventually eliminate the need for the highly complex recapture rules of current law.

* * *

This concludes my prepared remarks. I will be happy to answer your questions.

Chairman LaFalce. Thank you, Mr. McLure.

We will hear the testimony of the other witnesses. What is your time constraint?

Mr. McLure. I do need to be back, if I can, by 11 a.m., if it would be possible.

Chairman LaFalce. That will be difficult, but we will question you first, after we hear from the other witnesses.

Mr. Ackerman?

STATEMENT OF DONALD E. ACKERMAN, CHAIRMAN, COMMITTEE ON TAX POLICY, ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. Ackerman. I am Don E. Ackerman, general partner of J.H. Whitney & Co. of New York City and a member of the board of the National Venture Capital Association, NVCA, which represents 202 member firms, who have $12.8 billion under management.

On behalf of the NVCA and the industry, I appreciate the opportunity to testify concerning the tax proposal and its effect on the entrepreneurial climate in the U.S. economy.

In the area of tax policy, the primary interest of the NVCA is to maintain a significant differential between the tax on capital gains and that on other income; and to lower the present rate of tax on capital gains.

The administration tax proposal of May 29 accomplishes both of those objectives, and on balance, we support the plan, recognizing that for some taxpayers the absence of a deduction for capital gains taxes paid in State and city returns will effectively cause an increase in aggregate capital gains percentage levels.

We would also point out that the corporate gains rate remains at 28 percent. Notwithstanding these two concerns and being aware that we cannot expect this proposal to necessarily satisfy our total requirements, we reiterate our support of the plan in its present form.

Since the Steiger bill of 1978, and the further reduction of capital gains rates in 1981, entrepreneurial activity, risk investment and the infusion of equity capital into job-creating growth companies, has provided a healthy stimulus to our economy and the development of new technologies in our country.

It is a fact that growth companies create jobs, improve productivity and increase tax revenue; equity capital is the lifeblood of growth companies; equity capital is highly sensitive to the capital gains rate and the differential between the rate of tax on capital gains and that on other investment income.

Therefore, the administration capital gains proposal will increase the rate of job creation; increase the growth in tax collections from payroll, Social Security and corporate income; improve the deficit in the balance of payments; and enhance the rate of innovation in the economy.

We are submitting data with this testimony that supports these statements. The availability of risk capital is dramatically affected by Federal tax policy. The facts show there is a direct relationship between investments by venture capital firms in portfolio companies and the maximum rates on long-term capital gains.

There is significant historical evidence of this relationship. From the Tax Reform Act of 1969 through the Tax Reform Act of 1976, Congress raised the maximum capital gains tax from 25 to 49 percent. The effect on the venture capital industry was profound.

Disbursements to entrepreneurial companies by venture capital firms dropped from $450 million in 1969, down to $250 million in 1975, a 45-percent decrease. Even more serious, new private capital committed to venture firms dropped from $171 million in 1969 to a mere $10 million 6 years later, in 1975.

The high capital gains tax rates beginning in 1970 disrupted the capital markets and dried up the flow of funds into both over-the-counter markets and venture capital firms.

Price earnings ratios of OTC growth companies were depressed during the period of high capital gains taxes which both raised the cost of capital to growth companies and lowered the rate of return to risk investors on successful investments.

It was not until 1978, when rate of tax on capital gains was reduced to 28 percent, that risk capital once again began to flow into the marketplace. Just a year before the 1978 act, only $39 million in private capital had been committed to venture capital firms.

In 1978, with the enactment of the lowered rate, $570 million was committed, and disbursements to portfolio companies rose over 30 percent. The continuation of this lower capital gains tax rate enabled the industry to flourish and fund thousands of entrepreneurs.

By 1983, some $4.5 billion in private capital was committed to venture capital firms.

The revival of the over-the-counter market and initial public offerings also coincided with the capital gains reductions. It is important to recognize the critical linkage between healthy public capital markets and the availability of venture capital funds.

The OTC market provides the larger amounts of capital required by growth companies after their venture capital funded start-up period. The OTC market also provides the liquidity and pricing mechanism that permits investors to realize gains on venture investments.

The level of venture investing declines significantly if there is no availability of public market growth capital or opportunity for liquidity and acceptable price levels.

The capital gains differential has raised the after-tax rate of return for risk investing and has created healthy equity markets. The result is that a wide range of investors have committed to both venture and OTC investments.

Since on any given investment tax-exempt entities receive a higher tax rate of return than tax-paying entities, significant investments have been made in venture capital funds by tax-exempt sources.

It is clear that lower capital gains tax rates will result in stronger economic growth, more tax revenues, and an acceleration of the rate of innovation. Low capital gains rates have had a dramatic impact on the growth of innovative companies.

We offer the example of the electronics industry. From 1974 through 1977, the industry grew slowly, laboring under an effective maximum capital gains rate of 49 percent. In 1978, when that rate dropped to 28 percent, the annual payroll jumped from $19.7 billion to $24.1 billion.

That added an estimated $600 million in personal taxes paid, in just that year. The industry continued to expand, receiving another boost in 1981 when the effective rate was dropped again to 20 percent.

By 1983, payroll was estimated at $49.8 billion, an increase of over 100 percent from 5 years earlier. Personal taxes paid increased accordingly to $7.5 billion.

The hard data supports the case that the capital gains tax rate is critical to the flow of venture capital, and to the success of innovative young companies. In the interest of encouraging the continuing development of growth companies with their job creating capability, we urge the Congress to support the administration's tax proposal.

Thank you, Mr. Chairman, for the opportunity to appear before the committee.

[The prepared statement of Mr. Ackerman on behalf of the National Venture Capital Association follows:]

PREPARED STATEMENT OF DON E. ACKERMAN

I am Don E. Ackerman, general partner of J.H. Whitney & Co. of New York City and a member of the board of the National Venture Capital Association (NVCA), which represents 202 member firms, who have $12.8 billion under management. On behalf of the NVCA and the industry, I appreciate the opportunity to testify concerning the tax proposal and its effect on the entrepreneurial climate in the U.S. economy.

In the area of tax policy, the primary interest of the NVCA is to maintain a significant differential between the tax on capital gains and that on other income; and to lower the present rate of tax on capital gains.

The administration tax proposal of May 29 accomplishes both of those objectives and on balance we support the plan, recognizing that for some taxpayers the absence of a deduction for capital gains taxes paid in state and city returns will effectively cause an increase in aggregate capital gains percentage levels. We would also point out that the corporate gains rate remains at 28 percent. Nothwithstanding these two concerns and being aware that we cannot expect this proposal to necessarily satisfy our total requirements, we reiterate our support of the plan in its present form.

Since the Steiger bill of 1978 and the further reduction of capital gains rates in 1981, entrepreneurial activity, risk investment and the infusion of equity capital into job creating growth companies, has provided a healthy stimulus to our economy and the development of new technologies in our country.

It is a fact that:

- Growth companies create jobs, improve productivity and increase tax revenue.
- Equity capital is the lifeblood of growth companies.
- Equity capital is highly sensitive to the capital gains rate and the differential between the rate of tax on capital gains and that on other investment income.

Therefore, the Administration capital gains proposal will:

- Increase the rate of job creation.
- Increase the growth in tax collections from payroll, social security and corporate income.
- Improve the deficit in the balance of payments.
- Enhance the rate of innovation in the economy.

We are submitting data with this testimony that supports these statements. The availability of risk capital is dramatically affected by Federal tax policy. The facts show there is a direct relationship between investments by venture capital firms in portfolio companies and the maximum rates on long-term capital gains

There is significant historical evidence of this relationship. From the Tax Reform Act of 1969 through the Tax Reform Act of 1976, Congress raised the maximum capital gains tax from 25 to 49 percent. The effect on the venture capital industry was profound. Disbursements to entrepreneurial companies by venture capital firms dropped from $450 million in 1969, down to $250 million in 1975 -- a 45 percent decrease. Even more serious, new private capital committed to venture firms dropped from $171 million in 1969 to a mere $10 million six years later, in 1975. (see Table 1.)

The high capital gains tax rates beginning in 1970 disrupted the capital markets and dried up the flow of funds into both over the counter markets and venture capital firms. Price earnings ratios of OTC growth companies were depressed during the period of high capital gains taxes which both raised the cost of capital to growth companies and lowered the rate of return to risk investors on successful investments. (see Table 2)

It was not until 1978, when the rate of tax on capital gains was reduced to 28 percent, that risk capital once again began to flow into the marketplace. Just a year before the 1978 act, only $39 million in private capital had been committed to venture capital firms. In 1978, with the enactment of the lowered rate, $570 million was committed, and disbursements to portfolio companies rose over 30 percent. The continuation of this lower capital gains tax rate enabled the industry to flourish and fund thousands of entrepreneurs. By 1983, some $4.5 billion in private capital was committed to venture capital firms (see Table 3).

The revival of the over the counter market and initial public offerings also coincided with the capital gains reductions (see Table 4). It is important to recognize the critical linkage between healthy public capital markets and the availability of venture capital funds. The OTC market provides the larger amounts of capital required by growth companies after their venture capital funded start up period. The OTC market also provides the liquidity and pricing mechanism that permits investors to realize gains on venture investments. The level of venture investing declines significantly if there is no availability of public market growth capital or opportunity for liquidity and acceptable price levels.

The capital gains differential has raised the after tax rate of return for risk investing and has created healty equity markets. The result is that a wide range of investors have committed to both venture and OTC investments. Since on any given investment tax exempt entities receive a higher after tax rate of return than tax paying entities, significant investments have been made in venture capital funds by tax exempt sources.

It is clear that lower capital gains tax rates will result in stronger economic growth, more tax revenues, and an acceleration of the rate of innovation. Low capital gains rates have had a dramatic impact on the growth of innovative companies. We offer the example of the electronics industry. From 1974 through 1977, the industry grew slowly, laboring under effective maximum capital gains rate of 49 percent. In 1978, when that rate dropped to 28 percent, the annual payroll jumped from $19.7 billion to $24.1 billion. That added an estimated $600 million in personal taxes paid -- in just that year. The industry continued to expand, receiving another boost in 1981 when the effective rate was dropped again to 20 percent. By 1983, payroll was estimated at $49.8 billion -- an increase of over 100 percent from five years earlier. Personal taxes paid increased accordingly to $7.5 billion (see Table 5).

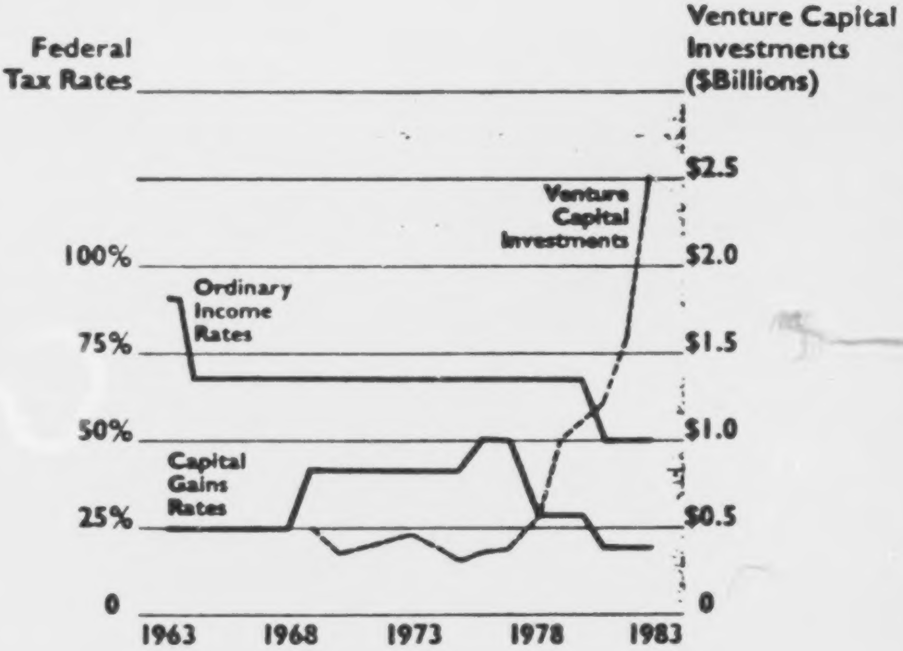
The hard data supports the case that the capital gains tax rate is critical to the flow of venture capital -- and to the success of innovative young companies. In the interest of encouraging the continuing development of growth companies with their job creating capability, we urge the Congress to support the Administration's tax proposal.

Thank you, Mr. Chairman, for the opportunity to appear before the committee.

TABLE 1

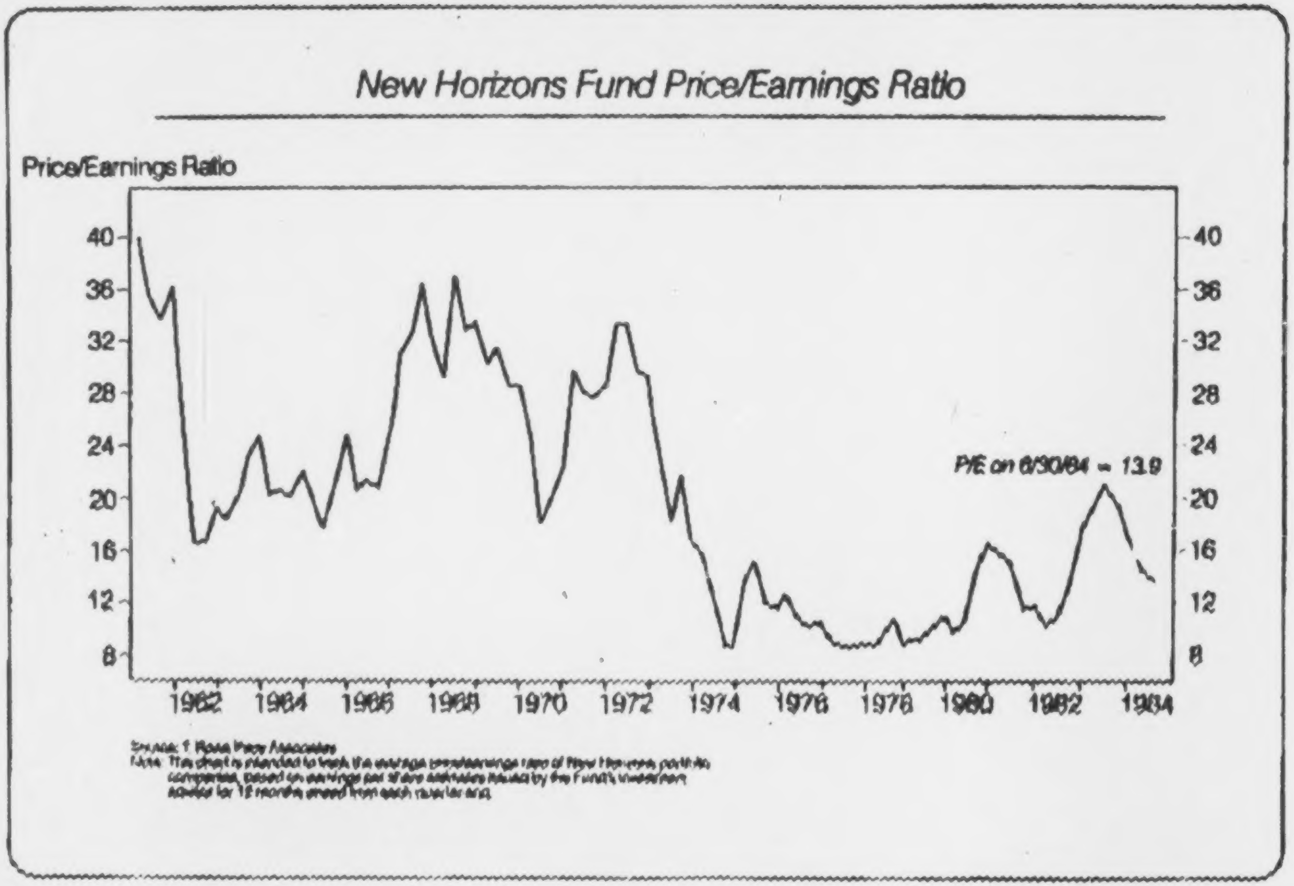
Influence of Tax Rates on Investments

Relationship between direct investments by venture capital firms in portfolio companies and the maximum rates on long-term capital gains and ordinary income



SOURCE: Syntrex Incorporated and Capital Publishing Company, 1983

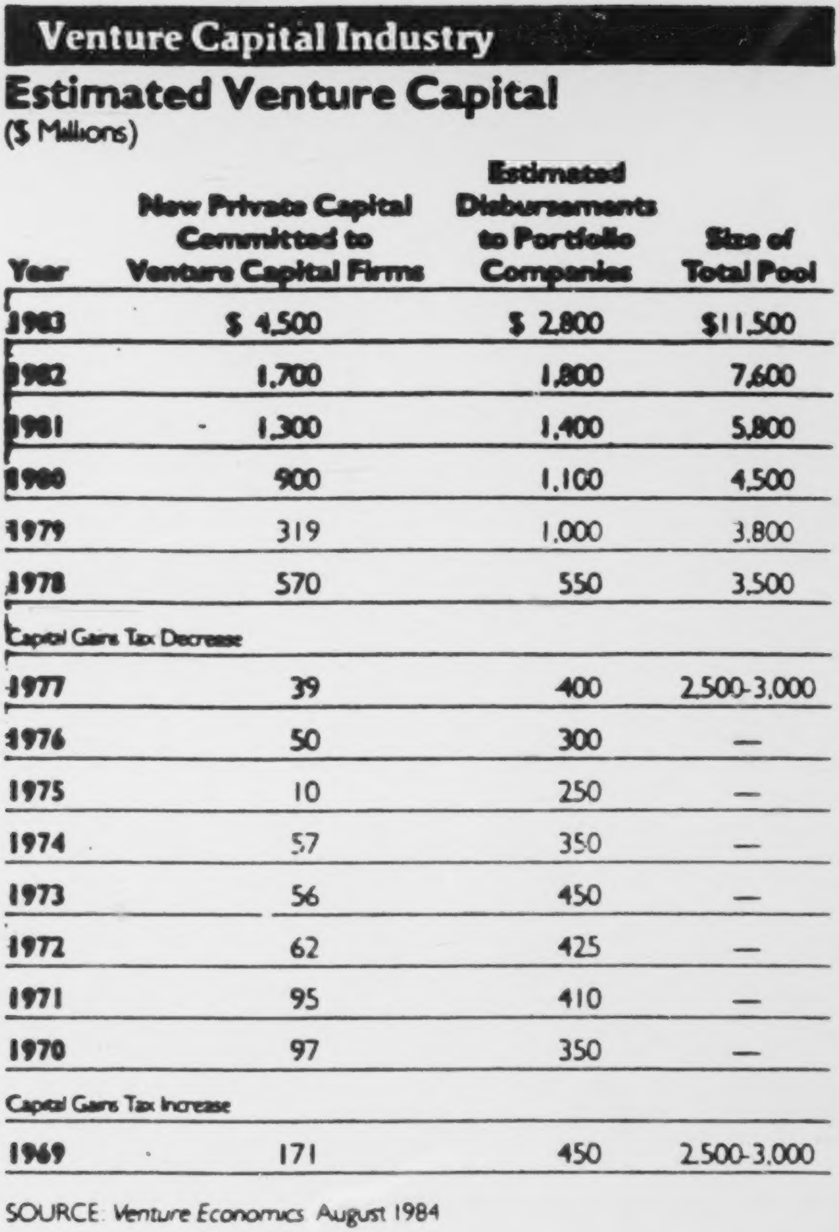
TABLE 2



New Horizons Fund Price/Earnings Ratio

Source: T. Rowe Price Associates
Note: This chart is intended to track the average price/earnings ratio of New Horizons portfolio companies, based on earnings per share estimates made by the Fund's investment adviser for 12 months ahead from each quarter end.

TABLE 3



Venture Capital Industry

Estimated Venture Capital

($ Millions)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Size of Total Pool
1983	$ 4,500	$ 2,800	$11,500
1982	1,700	1,800	7,600
1981	1,300	1,400	5,800
1980	900	1,100	4,500
1979	319	1,000	3,800
1978	570	550	3,500
Capital Gains Tax Decrease			
1977	39	400	2,500-3,000
1976	50	300	—
1975	10	250	—
1974	57	350	—
1973	56	450	—
1972	62	425	—
1971	95	410	—
1970	97	350	—
Capital Gains Tax Increase			
1969	171	450	2,500-3,000

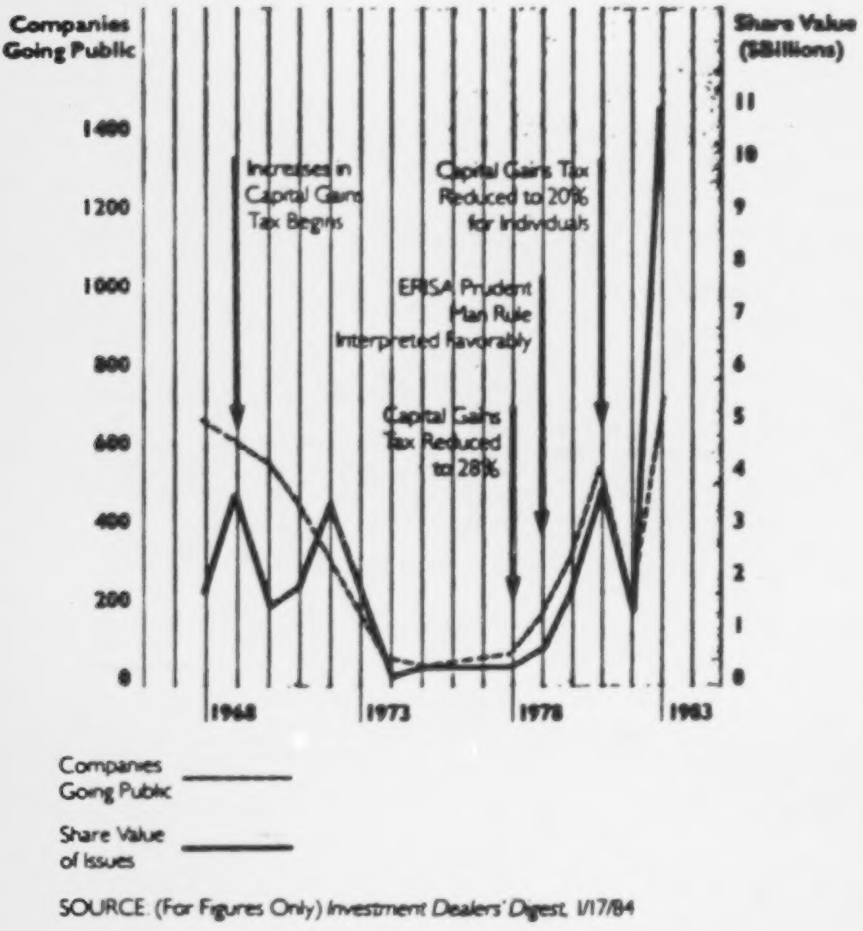
SOURCE: *Venture Economics* August 1984

TABLE 4

Policy and Rules Changes

Effect on Flow of Public Offerings

(Current Dollars)



SOURCE: (For Figures Only) *Investment Dealers' Digest*, 1/17/84

TABLE 5

SIZE OF U.S. ELECTRONICS INDUSTRIES, 1974-1983

Years	Number Employees	Annual Payroll (billions)	Estimated Personal Taxes Paid** (billions)	Capital Gains Effective Maximum Tax Rate
1974	1,440,000	$ 15.8	$ 2.4	49%
1975	1,300,000	15.9	2.4	49
1976	1,300,000	17.5	2.6	49
1977	1,430,000	19.7	3.0	49
1978	1,570,000	24.1	3.6	28
1979	1,790,000	29.3	4.4	28
1980	1,960,000	35.1	5.3	28
1981	1,970,000	39.8	6.0	20
1982	2,070,000	43.5*	6.5	20
1983	2,280,000	49.8*	7.5	20

* Data for 1974-1981 are AEA estimates based on data published in County Business Patterns. Data for 1982 and 1983 are AEA estimates based on data supplied to AEA by the Bureau of Labor Statistics. Comparable data is not available for years prior to 1974. The 1983 employment total includes selected service categories not included in prior years.

** Assumes average effective personal tax rate of 15%.

Chairman LaFalce. Thank you very much, Mr. Ackerman.

Our next witness will be Mr. Joseph Minarik, senior research associate for the Urban Institute.

Mr. Minarik?

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

Mr. Minarik. Thank you, Mr. Chairman.

Of the changes in the administration's tax reform proposal relative to the Treasury's original plan, those relating to capital gains taxation are surely among the most significant.

Along with modifications to provisions relating to depreciation and taxation of income from oil and gas, the capital gains decisions have at least to some degree changed the character of the package.

Chairman LaFalce. Once you have read the book, the movie that followed doesn't quite stack up.

Mr. Minarik. That seems to be the case to some people, Mr. Chairman.

In contrast to Treasury I, which would have taxed inflation-adjusted capital gains at ordinary rates, the administration's plan allows an exclusion equal to 50 percent of the nominal capital gain.

Given the Treasury's proposed maximum rate, this gives the highest-income taxpayers a tax cut on their long-term gains, to 17.5 percent from 20 percent.

The exclusion, compared to indexation, is relatively more generous to those who hold assets for a short time, and to those with large gains. Those with small gains or losses, and those who have held assets over the last two decades of rapid inflation, would tend to be better off with Treasury I's indexation.

The capital gains exclusion in the current law has been widely criticized on tax policy grounds for some time. While the exclusion is sometimes justified as a compensation for inflation, it is far from precise, and as noted above drastically overcompensates those who realized gains over short periods with little inflation.

The exclusion is also justified as an incentive to risky investment and capital formation, but much of its benefit is dissipated on tax shelters and assets that have little bearing on long-term economic growth.

In light of this criticism, it is somewhat surprising that the administration receded from its earlier position of taxing precisely inflation-adjusted capital gains at full rates.

In my opinion, the administration's retreat to a capital gains exclusion is unfortunate for these reasons. First, it perpetuates a number of technical problems with the current exclusion. Second, it causes an undesirable distributional outcome for the package as a whole. And third, it buys very little in terms of additional capital formation.

It is important to understand at the outset that capital gains taxation is necessarily a rough justice compromise between the investor and the exchequer. Given our fundamental choice to tax income, ideal taxation of capital gains is unattainable.

The problem is that we must tax capital gains when they are realized—that is, when the capital is sold, rather than on accrual—

that is, as the asset changes in value, year by year. Many difficulties of capital gains taxation would be avoided if we could tax the increase, or decrease, in value of every asset every year, whether the asset were sold or not.

Chairman LAFALCE. Under the recapture provision of this proposal, you are going to have certain taxation taking place, even though there has not been a realization.

Mr. MINARIK. That is true in some instances, too, Mr. Chairman.

Chairman LAFALCE. Isn't that rather novel?

Mr. MINARIK. We have some instances in the current tax law of taxation without realization, but they are relatively few. The imputed interest issue comes to mind, but it is relatively unusual, Mr. Chairman.

Accrual taxation is unattainable because of liquidity problems, and because both the Federal Government and investors would have to accommodate wide swings in tax liabilities as changes in business conditions sent asset values up and down.

Failing accrual taxation, we must tax capital gains as they are realized. This causes some serious difficulties, all of which arise because gains are taxed only when the taxpayer chooses. The first major problem is the distorting effect of inflation on measure capital gains, and hence, on tax liabilities.

If an asset increases in value by 10 percent over a period in which the price level increases at the same rate, the investor has no real gain. But under the current tax law, the investor must pay tax on 40 percent of this nominal gain, and thus pays a tax even though he has no real income.

The extra burden on some capital gains due to inflation is often cited by advocates of more lenient capital gains taxation.

A second problem in capital gains taxation on realization is called bunching. When a taxpayer realizes a large capital gain that has accumulated over a long period of time, the entire gain is taxed in a single year. That large gain might push the taxpayer up through several tax rate brackets, imposing a larger tax.

The bunching problem has received little attention of late, in part because the general income averaging provision of the current law helps to cushion the problem, and in part because taxes would reduce the range of tax rates.

As was mentioned at the outset, however, capital gains taxation is a rough justice compromise. Though our system gives investors some disadvantages, it gives them advantages as well. One important advantage is that the investor can choose if and when he will realize a gain and pay tax.

If he has a large, diversified portfolio, he can realize losses to offset any gains he chooses to cash in, and thus can avoid tax.

Further, by holding on to an appreciated asset, he can postpone taxation indefinitely. Such accrued and untaxed gains implicitly compound themselves tax-free over time. This is the classic problem of deferral of tax, which is equivalent to an interest-free loan to the taxpayer from the Government.

For this reason, there is a significant advantage to investments that throw off their income in the form of capital gains rather than dividends or interest, which are taxed currently.

A final advantage of investors is the specific provision of the tax law that allows inheritors of appreciated assets to take as their tax basis the value of the asset at the time of bequest.

Thus, if an investor buys stock for $100, the stock appreciates to $1,000, and the investor dies and leaves it to his heirs, the heirs can sell the stock for $1,000 with no taxable capital gain.

Because the investor himself never pays capital gains tax, the capital gain is never taxed at all. This provision is called the "step up of basis" of inherited property, or sometimes, less technically, the "death escape."

Another problem with our current tax treatment of capital gains is its inevitable implication for capital losses. For one thing, because we allow taxpayers to exclude part of their capital gains, we must also exclude part of their capital losses, to prevent tax-advantaged sales of matching gains and losses.

Further, because taxpayers with large diversified portfolios could choose to realize only their losses while holding their gains, thereby offsetting all income from other sources and paying no tax, we must restrict the amount of capital loss that may be offset against ordinary income, currently $3,000 per year.

Both of these restrictions on the deductibility of losses are assumed by economists to reduce risk-taking.

This combination of tax law provisions makes up the rough justice compromise of capital gains taxation. The administration's tax proposal does not deal directly with any of these problems.

Though Treasury I proposed to index capital gains precisely for inflation, and thus address at least one issue, the administration backed away and restored the exclusion.

As was noted above, the percentage exclusion is a most imprecise solution for the inflation problem. While the administration did cut the exclusion from 60 to 50 percent, thereby reducing the relative advantage of capital gains compared to ordinary income, the reduction of statutory rates leaves the maximum rate on capital gains lower than it is under current law.

It is interesting to consider the reaction of much of the investment community to Treasury I. Though investors have often argued for preferential treatment for capital gains on the ground of inflation, they protested when a precise remedy for the problem was offered.

It is also important to keep in mind that inflation is not the only technical problem afflicting capital gains taxation, and that the other problems work to the advantage of the taxpayer. Deferral and the death escape are seldom mentioned by lobbyists for more lenient capital gains taxation.

One problem with the capital gains exclusion in the current law that the administration did address, at least in part, is tax shelter conversion of ordinary income into capital gain. Many real estate tax shelters involve the depreciation of buildings using the straightline method over the short lifetime permitted by law.

Investors then sell the property at capital gains rates without recapture of the early depreciation that was offset against ordinary rates. This tax avoidance technique is cut off by the administration proposal, which requires that capital gains on depreciable assets be taxed at ordinary rates after an inflation adjustment.

While this part of the plan is admirable, one can only wonder why all capital gains were not restricted to this inflation-adjusted method, and whether the singling out of depreciable assets will not trigger requests to extend the exclusion to all assets.

One of the most controversial aspects of the administration's plan has been its substantial tax cut for upper income households. The household sector receives an overall tax cut of about 7 percent, but those with incomes over $200,000 receive a 10.7-percent tax reduction; those in the range from about $30,000 to $100,000 receive tax cuts significantly below the average. This pattern is considered by some to be unfair.

Treasury I, in contrast, gave the highest income taxpayers tax cuts that were quite close to the household-sector average. The cause of the swing between Treasury I and the administration plan is almost exclusively the change in the tax treatment of capital gains. Concessions to independent oil and gas producers contribute somewhat.

As noted earlier, the capital gains exclusion is relatively more generous to people with large gains. Further, taxpayers with very large incomes receive significant shares of their incomes in the form of large capital gains.

Taxpayers with adjusted gross incomes of over $200,000 in 1982 received 38.2 percent of their income in the form of tax-favored long-term capital gains. Those with incomes over $1 million received 58.5 percent of their income as capital gains.

Thus, the effect of the administration's concession on capital gains is perfectly predictable. And if the distributional pattern of the administration's plan is to be altered, it is worth remembering that a higher tax rate bracket will increase taxes most for those with ordinary income taxed at full rates.

The administration's concessions to capital gains may be made in hopes of improved capital formation and economic growth. If so, the basis for these concessions is slim, indeed.

Very little of our capital investment, year by year, comes from purchases of corporate equities by taxpayers who are subject to capital gains taxation. The great bulk of investment funds comes from corporate retained earnings and purchases of stock by tax-exempt entities such as pension funds and endowments of nontaxable institutions.

Thus, capital gains taxation has little direct influence, and the historical record tends to bear this out.

Some might argue that concessions for capital gains lead corporations to retain more earnings, so that they can make their shares appreciate and yield capital gains to their investors; and that this is a cause for greater investment. If so, it is a mixed blessing.

Most economists agree that the bias toward retained earnings prevents investment funds from being allocated among firms by the free market, and that this distortion leads to inefficiency and slower growth in the long run.

It was this tendency that was at the root of the administration's proposed dividends-paid deduction; but, of course, this deduction was greatly cut back between Treasury I and the administration plan.

Another argument for the capital gains preference is that it is a strong incentive for investment in new ventures. This argument is based in part upon claims that venture capital investments track changes in capital gains taxation quite closely, with booming investment when capital gains taxes are cut.

This argument is weak. New venture investments were down in the early 1970's, after the increase in capital gains taxes in the Tax Reform Act of 1969, but the economy in general was in turmoil over that period.

Venture capital investments picked up after the capital gains tax cut in 1978, but much of the increase in venture capital investments came from institutions that are nontaxable, including pension funds.

It has been argued that the liberalization of portfolio restrictions on pension funds in ERISA, at about the same time, was more responsible for the boom in venture capital investments than was the capital gains tax cut.

The alleged role of capital gains taxation in venture capital investments might also seem exaggerated in light of the shakeout among new ventures over the last 2 years, while tax treatment of capital gains did not change.

Another factor in the historical record is the development of new technologies. It is reasonable to argue that the genesis of microelectronics in the mid and late 1970's caused the boom in venture capital investments, rather than the other way around.

Economists might argue that the venture capital industry, which is risky, would benefit significantly from a liberalized tax treatment of capital losses. Anecdotally, however, venture capitalists seem to reject this approach, saying that they expect to reap capital gains and want more generous treatment of them.

They point to the records of some venture capital funds that have averaged rates of return in excess of 20 percent. While this argument may strike different people in different ways, one might ask why investments with average returns exceeding 20 percent need any special treatment from the tax system.

Other aspects of the administration's plan are already highly favorable to venture capital. Because new ventures tend not to benefit from other preferences in the Tax Code, they tend to have substantial taxable income and tax liabilities when they turn the corner to success.

Thus, they would benefit disproportionately from the reductions in corporate—for corporations—and individual—for sole proprietorships and partnerships—statutory tax rates.

In any event, cutting taxes on capital gains is a most inefficient approach to aiding venture capital. The revenue costs of capital gains tax cuts for all other investments are extremely large relative to the size of the venture capital industry.

One might easily imagine a $3 billion cut in capital gains taxes to benefit a $3 billion per year industry.

If the current tax treatment of capital gains is an uneasy compromise, the administration's proposal is more awkward still. While we must give credit for cutting off the capital gains exclusion for investments in depreciable assets, we might wonder why the administration did not stick to its original approach of full taxation of inflation-adjusted gains.

The benefits of this retreat are quite small, and the costs, especially in terms of the unbalanced distributional effect of the plan, are appreciable.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Minarik entitled, "Capital Gains Taxation in the Administration's Reform Plan," follows:]

Capital Gains Taxation in the Administration's Reform Plan

Testimony of

Joseph J. Minarik
Senior Research Associate
The Urban Institute

Before the

Subcommittee on Economic Stabilization
Committee on Banking, Finance, and Urban Affairs
U. S. House of Representatives

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CAPITAL GAINS TAXATION
UNDER THE ADMINISTRATION'S REFORM PLAN

Of the changes in the administration's tax reform proposal relative to the Treasury's original plan, those relating to capital gains taxation are surely among the most significant. Along with modifications to provisions relating to depreciation and taxation of income from oil and gas, the capital gains decisions have at least to some degree changed the character of the package.

In contrast to Treasury I, which would have taxed inflation-adjusted capital gains at ordinary rates, the administration's plan allows an exclusion equal to 50 percent of the nominal capital gain. Given the Treasury's proposed maximum rate, this gives the highest-income taxpayers a tax cut on their long-term gains, to 17.5 percent (that is, the 50 percent of capital gain that is taxed times the 35 percent ordinary maximum rate) from 20 percent (the 40 percent of capital gains now taxed times the maximum current-law rate of 50 percent). The exclusion, relative to indexation, is relatively more generous to those with relatively short-term gains, and to those with large gains. Those with small gains or losses, and those who have held assets over the last two decades of rapid inflation, would tend to be better off with Treasury I's indexation.

The capital gains exclusion in the current law has been widely criticized on tax policy grounds for some time. While the exclusion is sometimes justified as a compensation for inflation, it is far from precise, and as noted above drastically overcompensates those who realized gains over short periods with little inflation. The exclusion is also justified as an incentive to risky investment and capital formation, but much of its benefit is dissipated on tax shelters and assets that have little bearing on long-term economic growth. In light of this criticism, it is somewhat surprising that the administration receded from its earlier position of taxing precisely inflation-adjusted capital gains at full rates.

In my opinion, the administration's retreat to a capital gains exclusion causes difficulties in three areas. First, it perpetuates a number of technical problems with the current exclusion. Second, it causes an undesirable distributional outcome for the package as a whole. And third, it buys very little in terms of additional capital formation.

PROBLEMS WITH THE CAPITAL GAINS EXCLUSION

It is important to understand at the outset that capital gains taxation is necessarily a rough justice compromise between the investor and the exchequer. Given our fundamental choice to tax income, ideal taxation of capital gains is unattainable. The problem is that we must tax capital gains when they are realized (that is, when the capital asset is sold), rather than on accrual (that is, as the asset changes in value, year by year). Many difficulties of capital gains taxation would be avoided if we could tax the increase (or decrease) in value of every asset every year, whether the asset were sold or not.

Accrual taxation is unattainable for a number of reasons. One is the impossibility of determining the changes in the values of some assets that are not sold (values of investment antiques or real estate are not quoted on national exchanges as are those of stocks and bonds). Another is that investors holding much of their wealth in the form of indivisible assets (such as businesses or some real estate) could have liquidity problems if they had to pay capital gains tax on the appreciation of their assets but had little cash income from which to pay it. And a final reason is that both the federal government and investors would have to accommodate wide swings in tax liabilities as changes in business conditions sent asset values up and down.

Failing accrual taxation, we must tax capital gains as they are realized. This causes some serious difficulties, all of which arise because gains are taxed only when the taxpayer chooses. The first major problem is the distorting effect of inflation on measured capital gains, and hence, on tax liabilities. If an asset increases in value by 10 percent over a period in which the price level increases at the same rate, the investor has no real gain. But under the current tax law, the investor must pay tax on 40 percent of his nominal gain, and thus pays a tax even though he has no real income.

If we taxed on accrual, inflation adjustments could be carried out on all assets at the same inflation rate every year, and thus would be quite simple. Taxation on realization means that each asset that is sold would have to be indexed according to inflation over its own precise holding period, and so indexation would be much more complex. This complexity is surely part of the reason why we have not indexed capital gains. (Another reason is probably that until the last ten years inflation was comparatively modest and uniform, and so the simple exclusion seemed a more acceptable approximation than it does now.) The extra burden on some capital gains due to inflation is often cited by advocates of more lenient capital gains taxation.

A second problem in capital gains taxation on realization is called bunching. When a taxpayer realizes a large capital gain that has accumulated over a long period of time, the entire gain is taxed in a single year. That large gain might push the taxpayer up through several tax rate brackets, imposing a larger tax than would be due if the gain were taxed in smaller installments over all the years when the gain was accumulating. Like the inflation problem, the bunching problem tends to increase tax liabilities relative to what might be due under a tax system closer to the ideal. The bunching problem has received little attention of late, in part because the general income averaging provision of the current law helps to cushion the problem, and in part because all tax reform packages extant would reduce the range of tax rates so much that the extra burden on a bunched gain would be significantly smaller.

As was mentioned at the outset, however, capital gains taxation is a rough justice compromise. Though our system gives investors some disadvantages, it gives them advantages as well. One important advantage arises directly from taxation only upon realization. The investors can choose if and when he will realize a gain and pay tax. If he has a large, diversified portfolio, he can realize losses to offset any gains he chooses to cash in, and thus can avoid tax. Further, by holding on to an appreciated asset, he can postpone taxation indefinitely. Such accrued and untaxed gains implicitly compound themselves tax free over time. This is the classic problem of deferral of tax, which is equivalent to an interest-free loan to the taxpayer from the government. For this reason, there is a significant advantage to investments that throw off their income in the form of capital gains rather than dividends or interest, which are taxed currently.

A final advantage of investors is the specific provision of the tax law that allows inheritors of appreciated assets to take as their tax basis the value of the asset at the time of bequest. Thus, if an investor buys stock for $100, the stock appreciates to $1000, and the investor dies and leaves it to his heirs, the heirs can sell the stock for $1000 with no taxable capital gain. Because the investor himself never pays capital gains tax, the capital gain is never taxed at all. This provision is called the "step up of basis" of inherited property, or sometimes, less technically, the "death escape."

Another problem with our current tax treatment of capital gains is its inevitable implications for capital losses. For one thing, because we allow taxpayers to exclude part of their capital gains, we must also exclude part of their capital losses, to prevent tax-advantaged sales of matching gains and losses. Further, because taxpayers with large diversified portfolios could choose to realize only their losses while holding their gains, thereby offsetting all income from other sources and paying no tax, we must restrict the amount of capital loss that may be offset against ordinary income (currently $3000 per year). Both of these restrictions on the deductibility of losses are assumed by economists to reduce risk-taking.

This combination of tax law provisions makes up the rough justice compromise of capital gains taxation. The administration's tax proposal does not deal directly with any of these problems. Though Treasury I proposed to index capital gains precisely for inflation, and thus address at least one issue, the administration backed away and restored the exclusion. As was noted above, the percentage exclusion is a most imprecise solution for the inflation problem. While the administration did cut the exclusion from 60 to 50 percent, thereby reducing the relative advantage of capital gains compared to ordinary income, the reduction of statutory rates leaves the maximum rate on capital gains lower than it is under current law.

It is interesting to consider the reaction of much of the investment community to Treasury I. Though investors have often argued for preferential treatment for capital gains on the ground of inflation, they protested when a precise remedy for the problem was offered. It is also important to keep in mind that inflation is not the only technical problem afflicting capital gains taxation, and that the other problems work to the advantage of the taxpayer. Deferral and the death escape are seldom mentioned by lobbyists for more lenient capital gains taxation.

One problem with the capital gains exclusion in the current law that the administration did address, at least in part, is tax-shelter conversion of ordinary income into capital gain. Many real estate tax shelters involve the depreciation of buildings using the straightline method over the short lifetime permitted by law. They then sell the property at capital gains rates without recapture of the early depreciation that was offset against ordinary rates. This tax avoidance technique is cut off by the administration proposal, which requires that capital gains on depreciable assets be taxed at ordinary rates after an inflation adjustment. While this part of the plan is admirable, one can only wonder why all capital gains were not restricted to this inflation-adjusted method, and whether the singling out of depreciable assets will not trigger requests to extend the exclusion to all assets.

DISTRIBUTIONAL EFFECTS OF THE ADMINISTRATION'S PLAN

One of the most controversial aspects of the administration's plan has been its substantial tax cut for upper-income households. The household sector receives an overall tax cut of about 7 percent, but those with incomes over $200,000 receive a 10.7 percent tax reduction; those in the range from about $30,000 to $100,000 receive tax cuts significantly below the average. This pattern is considered by some to be unfair.

Treasury I, in contrast, gave the highest-income taxpayers tax cuts that were quite close to the household-sector average. The cause of the swing between Treasury I and the administration plan is almost exclusively the change in the tax treatment of capital gains. (Concessions to independent oil and gas producers contribute somewhat.)

As was noted earlier, the capital gains exclusion is relatively more generous to people with large gains than would be the indexation in Treasury I. Further, taxpayers with very large incomes receive significant shares of their incomes in the form of large capital gains. Taxpayers with adjusted gross incomes of over $200,000 in 1982 received 38.2 percent of their income in the form of tax-favored long-term capital gains. Those with incomes over $1 million received 58.5 percent of their income as capital gains. Thus, the effect of the administration's concession on capital gains is perfectly predictable. And if the distributional pattern of the administration's plan is to be altered, it is worth remembering that a higher tax rate bracket will increase taxes most for those with ordinary income taxed at full rates.

ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION

The administration's concessions to capital gains may be made in hopes of improved capital formation and economic growth. If so, the basis for these concessions is slim indeed.

Very little of our capital investment, year by year, comes from purchases of corporate equities by taxpayers who are subject to capital gains taxation. The great bulk of investment funds comes from corporate retained earnings and purchases of stock by tax-exempt entities such as pension funds and endowments of nontaxable institutions. Thus, capital gains taxation has little direct influence, and the historical record tends to bear this out.

Some might argue that concessions for capital gains lead corporations to retain more earnings, so that they can make their shares appreciate and yield capital gains to their investors; and that this is a cause of greater investment. If so, it is a mixed blessing. Most economists agree that the bias toward retained earnings prevents investment funds from being allocated among firms by the free market, and that this distortion leads to inefficiency and slower growth in the long run. It was this tendency that was at the root of the administration's proposed dividends-paid deduction; but of course, this deduction was greatly cut back between Treasury I and the administration plan.

Another argument for the capital gains preference is that it is a strong incentive for investment in new ventures. This argument is based in part upon claims that venture capital investments track changes in capital gains taxation quite closely, with booming investment when capital gains taxes are cut. This argument is weak. New venture investments were down in the early 1970s, after the increase in capital gains taxes in the Tax Reform Act of 1969, but the economy in general was in turmoil over that period. Venture capital investments picked up after the capital gains tax cut in 1978, but much of the increase in venture capital investments came from institutions that are nontaxable, including pension funds. It has been argued that the liberalization of portfolio restrictions on pension funds in ERISA, at about the same time, was more responsible for the boom in venture capital investments than was the capital gains tax cut. The alleged role of capital gains taxation in venture capital investments might also seem exaggerated in light of the shake-out among new ventures over the last two years, while tax treatment of capital gains did not change.

Another factor in the historical record is the development of new technologies. It is reasonable to argue that the genesis of microelectronics in the mid- and late-1970s caused the boom in venture capital investments, rather than the other way around.

Economists might argue that the venture capital industry, which is risky, would benefit significantly from a liberalized tax treatment of capital losses. Anecdotally, however, venture capitalists seem to reject this approach, saying that they expect to reap capital gains and want more generous treatment of them. They point to the records of some venture capital funds that have averaged rates of return in excess of 20 percent. While this approach may strike different people in different ways, one might ask why investments with average returns exceeding 20 percent need any special treatment from the tax system.

Other aspects of the administration's plan are already highly favorable to venture capital. Because new ventures tend not to benefit from other preferences in the tax code, they tend to have substantial taxable income and tax liabilities when they turn the corner to success. Thus, they would benefit disproportionately from the reductions in corporate (for corporations) and individual (for sole proprietorships and partnerships) statutory tax rates.

In any event, cutting taxes on capital gains is a most inefficient approach to aiding venture capital. The revenue costs of capital gains tax cuts for all other investments are extremely large relative to the size of the venture capital industry.

CONCLUSION

If the current tax treatment of capital gains is an uneasy compromise, the administration's proposal is more awkward still. While we must give credit for cutting off the capital gains exclusion for investments in depreciable assets, we might wonder why the administration did not stick to its original approach of full taxation of inflation-adjusted gains. The benefits of this retreat are quite small, and the costs, especially in terms of the unbalanced distributional effect of the plan, are appreciable.

Chairman **LaFalce**. Thank you very much, Mr. Minarik.

Mr. McLure, we have had many changes in the tax law over the years, but how long has it been since we have only permitted the loss of $3,000 to be deducted?

Mr. **McLure**. I would have to check that for the record. It is relatively recent.

Chairman **LaFalce**. Recent?

Mr. **McLure**. It was $1,000 up until fairly recently.

Chairman **LaFalce**. It has been $3,000 for a long time.

Mr. **Minarik**. 1978.

Chairman **LaFalce**. Long or recent is relative, I guess. Don't you think that increasing that to at least accommodate the change in inflation that has taken place from 1979 to the present might be not only a helpful risk investment, but also equitable?

Mr. **McLure**. That is something that certainly could be considered. There, obviously, is a problem with unlimited deductibility of losses because of the problem of selective pruning of the portfolio to let the gains run and realize the losses.

Whether $3,000 is the right number is reasonably debatable.

Chairman **LaFalce**. Mr. Ackerman, do you have any idea on that issue?

Mr. **Ackerman**. No; Mr. Chairman.

Mr. **Minarik**. I would suggest that is a reasonable way to go, again subject to the problem of the selective pruning of the portfolio, as Charlie put it. One might perhaps accommodate capital losses in particular industries more easily than one could accommodate capital gains in particular industries, but the danger of tax sheltering also has to be taken into account.

Chairman **LaFalce**. Treasury I initially proposed the indexation of your gains and your treatment of those gains as ordinary income. Reagan I permits that, as I understand it, basically as an option between what, 1991?

Initially, Treasury thought that that was technically feasible, and now we are not sure what your position is, and we will try to work out a technically feasible manner between now and 1991. That leads me to think that is still a thought that you wouldn't even permit it as an option, but that you might eliminate it between now and 1991, if you don't deem that it is technically feasible.

Mr. Minarik, what are your thoughts about the technical feasibility of using indexation?

Mr. **Minarik**. Well, Mr. Chairman, there is no question that it is tricky for the individual taxpayer, and as I pointed out in my written statement, part of the problem is that when you tax upon realization, it means that every individual asset that is sold has to be individually indexed for inflation since the time it was purchased, so that involves a lot of paperwork.

Apparently, there are also some complications when one is dealing with the depreciable assets the administration dealt with in terms of recapture problems. It is not necessarily an easy thing to do.

Chairman **LaFalce**. How did you envision that it would be done, Mr. McLure, when you helped draft Treasury I?

Mr. **McLure**. Well, let me try to explain that at the same time that I address the question of complexity. The idea, of course, in Treasury I was that the basis of the asset would be written up to reflect the amount of inflation that occurred between the time of acquisition of an asset and the time of disposition.

I think for many assets, that would be relatively easy to implement. It would amount to looking up a number in a table and multiplying to calculate the adjusted basis.

One of the things that was impressed upon us in the intervening period between Treasury I and the administration proposals, was that there would be substantial problems in implementation for certain kinds of assets.

One example would be mutual funds, where there are simply a great number of purchases and sales, each of which would have to be adjusted individually.

Now, that would all be computerized, but any time an individual would own shares, and perhaps add to and subtract from the ownership of shares, there would have to be adjustments.

Under current law, all you need to know really is whether or not you have held the asset for more or less than 6 months, and the acquisition cost, the purchase price.

Under the Treasury I proposal, you would need to know for each asset exactly when it was purchased, and this could involve, we felt, substantial complexity.

This was one of the reasons why we felt that perhaps——

Chairman **LaFalce**. I am going to return to that issue, and I have a few more questions before I leave. I will return, and you may not be here, so let me get off of that and on to two of my basic concerns.

The unbelievable about-face the Treasury made, or the administration made, with respect to the Treasury proposal, I mean, it was not a question simply of backtracking from Treasury I to the status quo.

It was going beyond that and permitting an effective maximum capital gains tax rate of 17.5 percent. At the very least, it seems you could have retained the status quo by not going from a 60-percent exclusion rule to 50 percent, and keeping the capital tax rate at 20 percent.

I can understand why you say there are technical difficulties there. How can you justify in going from 60 to 50 percent and permitting a lower than 20 percent rate, given the rhetoric that I have in front of me of the rationale for Treasury I?

Mr. **McLure**. There was some uneasiness in putting together Treasury I regarding the fact, that there would not be any preferential treatment whatsoever for capital gains.

Chairman **LaFalce**. If there was uneasiness, you hit it fairly well in your statement with respect to your treatment of capital gains in Treasury I.

Mr. **McLure**. With the reduction in the tax rate on long-term capital gains from 20 to 17.5 percent, the rate is reduced, but relative to the rate on ordinary income, of course, the rate differential is reduced because the exclusion is reduced from 60 to 50 percent.

Mr. **Ackerman**. Mr. Chairman, I would like to point out that residents of your State, when you look at the aggregate of State and city taxes and the Federal tax on capital gains, in fact, have a 17-percent increase in capital gains tax in total because of the elimination of the deductibility.

Chairman LaFalce. We are going to eliminate that provision from the proposal, Mr. Ackerman.

Mr. Ackerman. I realize that is a major part of the program for people from New York, but in fact, as presented, it is an aggregate increase.

Chairman LaFalce. A quick question and a quick response, if you can. If you want to help venture capital, it seems to me, that using this type of tax treatment, while it will help venture capital, is probably about the most inefficient means that you could devise, that there would be other means that would be much more efficient and therefore less costly, that this is such an untargeted blunderbuss approach, if you will, that we waste an awful lot of money in order to be of assistance to venture capital?

Mr. McLure. We did look at options that might have included trying to target the capital gains preference more narrowly to new corporations, new ventures, or new issues of various types.

There are severe technical problems in trying to achieve that kind of targeting. Ultimately, it was decided to go with this approach.

Chairman LaFalce. We will resume in approximately 15 minutes, and recess for the purpose of making two votes on the floor of the House.

[Recess.]

Chairman LaFalce. The subcommittee will resume its hearing.

I am pleased you were able to remain with us a little bit longer, Mr. McLure. We were discussing a number of issues, as I recall, on the technical feasibility of using indexation, the rationale for going to a lower maximum capital gains rate than current law, in light of the previous Treasury Department explanation, and the efficiency of using preferential capital gains rate treatment as a means of assisting venture capital.

Treasury I, page 181, Simplication:

> The sharp distinction in tax rates under current law between capital gains and ordinary income has been the source of substantial complexity.
>
> Application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source.
>
> A significant body of law, based both in the tax code and in judicial rules, has developed to deal with these matters. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case.
>
> The taxpayer and Internal Revenue Service resources consumed in this process are substantial, yet there is little basis for confidence that the results derived in particular cases are even roughly consistent.

In light of that, Mr. McLure, it is difficult for me still to understand how you backtrack.

Mr. McLure. I can only repeat that we saw some complexity in the implementation of the indexing provision. I grant that the complications may have been less than those that you have just identified in the passage that you read, but they certainly were there. Again, we also were concerned that taxing capital gains, as ordinary income might go too far in terms of eliminating the preference totally.

Of course, once you decide that there should be some preference, then you do lose exactly the kinds of gain in simplicity that you have just mentioned. On balance, we decided in Treasury I that the simplicity advantage of eliminating the characterization problem outweighed the growth innovation, and capital formation objectives and in the President's proposals, we decided the other way.

It is a tough decision.

Chairman **LaFalce**. Mr. Minarik?

Mr. **Minarik**. Yes, Mr. Chairman.

Let me suggest one point, I think, in favor of what Charlie is saying, and a couple going the other way. As far as the characterization problem is concerned, so long as we have the fundamental difficulty that gains and losses are taxed or deducted as realized, we continue to have the problem of how we deal with losses.

To the extent that even under Treasury I, there would have to be restrictions on the amount of capital loss that is deductible against ordinary income, you would continue to have a problem with the characterization of capital loss, even if you did not have as much of a problem with capital gains. So, the original Treasury position, I think, states the simplicity advantages on the gains side, but it should be amended to add that there would continue to be some problems on the loss side.

Let me say one thing about Charlie's earlier point with respect to mutual funds, that there is a problem when you sell, that you have a string of purchases over a long period of time when there is reinvestment of dividends within the mutual funds, for example.

The real problem there is determining which shares of the mutual fund are the ones you sold, when you sell part of it.

Chairman **LaFalce**. Isn't that almost impossible?

Mr. **Minarik**. You have to have a rule. You have to either decide that you are selling on a last-in, first-out basis, or on a first-in, first-out basis.

But once you allow for the fact that that decision has to be made with or without indexing, the real question is how much more complicated is it to do an indexation computation on top of that, whether it is a first-in, first-out or a last-in, first-out realization?

I think that it is probably reasonable to say that once the decision is made as to which mutual fund shares are the ones that were realized, that the additional computation on the basis of indexation is really not that complicated.

That is the same kind of computation——

Chairman **LaFalce**. A little different from the other one?

Mr. **Minarik**. You might have to deal with a dozen different purchases on one sale, each of which has to be indexed separately, but that is no different from selling 12 different blocks of stocks.

It is the same problem we have under the current law. Once that complication is dealt with, and you have to deal with that whether you index or not, the indexation on top of that is not so much of a big deal.

Chairman **LaFalce**. Isn't there a fundamental dichotomy, though, between the concept of indexation and the concept of simplicity?

Mr. **Minarik**. To some degree that is true, Mr. Chairman, and that is something that we have to decide not only on capital gains, but also on depreciation.

Chairman **LaFalce**. Isn't there also a fundamental phoniness in the argument of simplicity insofar as tax reform approaches are concerned?

Really, there is nothing more simple about determining which rate is applicable to you, if you have to look at a tax table that has three rates, as opposed to a tax table which contains 14 rates.

The only argument you could make for greater simplicity under a Tax Code is that more individuals would be able to file short forms under the tax proposal than under current law, and that you could say makes it more simple.

Mr. **Minarik**. If I may, Mr. Chairman, let me point out that there are two different kinds of simplicity that we have to consider here. One is the simplicity of actually filling out the forms, and that is what you are referring to, and there are some gains to be made there.

Chairman **LaFalce**. I do think that when the argument of simplification is made, it is made almost exclusively with respect to simplicity in those terms, as opposed to tax neutrality, insofar as investment decisions are concerned.

I don't think that simplicity is advanced for an argument on behalf of neutrality.

Mr. **Minarik**. Mr. Chairman, to the extent that I am permitted to plug my book, I might suggest that I tried to draw the distinction there, and personally, I think that when one talks about tax simplification, probably one of the most important areas is having people make deals on the basis of economics, rather than on the basis of tax law.

In that regard, I think that probably the Treasury and other people in favor of tax reform would argue that there is a simplification aspect here, and that it is important. The judgment call is whether any particular proposal achieves very much in that regard, and that is something that you have to make a determination on.

Mr. **Ackerman**. With respect to the indexation versus the exclusion approach, there is a difference between the different types of assets.

For example, the IRS Bulletin, IRS Statistics Bulletin, in the summer of 1982, they reported some statistics from tax returns for 1973, and pointed out that the corporate securities transactions represented 42 percent of the transactions, but only 15 percent of the gains, so that is characteristic, a very high transaction level and lots of complexity if you are going to index those items, versus if you are dealing with large assets such as real estate, relatively few transactions.

The other point is that there is a major difference between those types of assets as well, in the theory of taxation, with respect to corporate equity, what causes the underlying value of corporate equity to increase is the fact that the corporation retains its earnings and the corporation, in fact, has paid a tax on those earnings that it has retained.

The increase in value, if it is just the book value, has already been taxed once. Now, it is not exactly a one-and-one correlation, because market prices fluctuate, but there has been a tax levy on the appreciation in the stock once within the corporation, similar to the double taxation on dividends.

That is very different than an asset that is held and depreciated and sold again later, which gives an opportunity to convert ordinary income into capital gains.

That is not the case with corporate equities, so there are very good justifications for treating different classes of capital assets differently.

Chairman LaFalce. Mr. McLure, I could understand how the administration could choose either current law, or Treasury I or its 17.5 percent maximum, but what is the rationale—or I could also understand how you would go to 17.5 percent immediately, and then basically go to Treasury I in 1991, with the thought in mind if you can't work out something technically, it would change between now and 1991, but what is the rationale for permitting alternative treatment, whichever is more preferable to the taxpayer?

Mr. McLure. I think there the problem is that the exclusion, of course, does not deal at all with the case of someone who has made an investment that has not appreciated in nominal terms as fast as the rate of inflation, and therefore, has realized a real loss.

In fact, it is quite possible under current law to have a nominal capital gain that is taxed where you actually have a real capital loss.

The exclusion does not deal with that, whereas indexing does. This choice allows the taxpayer the use of indexing for accurate measurement of the real capital loss on the one hand, but on the other hand, allows the more favorable treatment of the exclusion for the really high payoff investments where——

Chairman LaFalce. Shouldn't you be able to make the alternative applicable only if its end result would be in situations where there is a real capital loss?

You would make it applicable not only where there has been a real capital loss, you would permit its applicability when there has been a tremendous, enormous capital gain, too?

Mr. McLure. Presumably, the taxpayer would choose, and obviously would tend to choose the right approach.

Chairman LaFalce. That would be a much more direct way to approach it, and would that permit the indexation of the $3,000 figure? I am not sure about that.

Mr. Minarik. I was going to ask, Mr. Chairman, as I understand the Treasury proposal, the taxpayer would make the election between indexation and the exclusion on a year-by-year basis, and that that decision would apply to all of his transactions in that year?

In other words, you would have to index all of them, or you would have to take the exclusion on all of them, which is a "let's make a deal" approach to determining the taxable gain in any given year. If you have a diversified portfolio and you have got some real estate that appreciated gradually over a long period of time, and you made a couple of hot choices in the stock market, and they went up a lot in 1 year—if you realize your real estate and your stock in the same year, you have to work it out both ways.

And you might very well wind up a lot worse off than if you realized the stock in 1 year to take the exclusion, and held off your real estate until next year, so you could index.

I don't know to what degree investors with a lot of money to invest spread their money between real estate and stocks. Having to choose every year to do it one way or the other, no matter what you sold, Mr. Chairman——

Chairman **LaFalce**. That doesn't assist us in the concept of simplification. You would be making your investment decisions, at least with respect to when to sell, primarily on the basis of tax consequences?

Mr. **Minarik**. You would unquestionably need to do it twice unless you had one or two large sales that dominate everything else, or all your sales are exactly the same character, and you know right off you would either index or use the exclusion.

Chairman **LaFalce**. Are we sure that—we made recommendations, we don't have bills. Do the recommendations say specifically whether they talk about making an aggregate decision on an annual basis or whether you can make a dozen different individual decisions within 1 year?

Mr. **McLure**. The recommendations currently are to make the same decision for all gains realized in 1 year.

This is an area that may need further study. One can think of a variety of different ways in which one might make the decision. Some theories would be wrong. For example, one might say you have to decide going into the investment which approach you are going to elect, but that doesn't really make any sense, because you don't know going in whether you are going to have a gain or a real loss.

You couldn't very well adopt that approach. The proposed approach is one that is reasonable, given a first look.

Chairman **LaFalce**. I am a little concerned about what I consider to be rather fiscal connections that have been made between lower capital gains tax rates and increases in venture capital, especially because of what I understand to be primary infusions of venture capital from nontaxable entities.

Would anybody want to expand upon that issue?

Mr. **Ackerman**. We have a rather intricate system here of capital markets which makes the whole process work, and a lot of the discussion tends to overlook the fact that the whole venture capital process doesn't get started, unless we have good viable public markets, particularly over-the-counter market and an initial public offering markets, because the funding of companies at the venture capital stage is only a small part of the funds.

Our data shows that new companies of the class that we back are totally dependent on venture funding for most of the first 3 years of their life, and the average company consumes about $8 million of equity capital during that period.

The next 3 years of its life, it is generally dependent on the public markets and the amount of capital required is nearly three times, approximately $32 million, so that by the time a company reaches its sixth year, its capital requirements have been close to $40 million.

If you don't have visibility on being able to raise that larger amount of capital later on, you don't start the process in the beginning.

If you don't have visibility on getting good prices later on, when you raise that capital, you don't start because you get diluted down, and the returns are very low, so it is basically the healthy equity markets as a whole that make it an attractive process to start new companies.

If you have healthy equity markets which have a large number of individual participants, as well as tax-exempt institutions, then you will have a flow of funds at the start of the process, and it is really then a return on investment gain.

And as I pointed out, if you make the after-tax returns attractive to taxable entities, they will automatically be attractive to tax-exempt entities, because they are not sharing the return with the Government, so it is not surprising that tax-exempt entities come in at the venture capital stage. So our view is that the two are so intertwined, that if you do not make it attractive to make risk investments, then you will kill the public markets as happened throughout the middle seventies, and you will not then have the flow of funds into the venture stage.

Chairman **LaFalce**. Mr. Minarik?

Mr. **Minarik**. I would just say something about the whole philosophy here. It seems to me that what we are trying to do right now in providing a capital gains exclusion is to give one particular sector of the economy a relative advantage.

The reason why we can't give them a relative advantage is that there are a lot of other sectors that have their own relative advantages.

We have a tax break for firms that are intensive in R&D.

Chairman **LaFalce**. Does the Reagan proposal maintain the R&D?

Mr. **McLure**. Yes, but it attempts to target it more narrowly toward expenditures that really are research and experimentation, rather than simply a reclassification of other kinds of expenditures.

Mr. **Minarik**. So investors of this sort are seen as having the opportunity to take advantage of a tax break for a capital incentive firm, or for an R&D intensive firm, to go into tax exempt bonds, oil and gas. The idea is, in order to compensate for these tax breaks in these areas, we give a capital gains exclusion so some capital will go into this other area.

It seems to me that this whole process has been self-defeating, and I think that that has been the understanding of a lot of people for a long time—attempting to provide relative advantages to different sectors to balance out. We have this philosophy that if there is a tax advantage in area A, that the only way we can possibly deal with that problem is to give a tax advantage to area B.

And it seems to me that what a real reform of the income tax system could do would be to change the venture capital sector from having a relative advantage to having an absolute advantage, not in the sense that it gets a tax break that some other sector does not get, but by clearing the decks and having firms compete for capital on the basis of their prospective rate of return. The venture capital sector could appeal for capital on the basis that it provides very high rates of return.

If you were to combine that with the best possible treatment of the losses that are involved in that process, it seems to me that the venture capital sector of the economy should be able to compete more favorably for capital. It is clearly an awkward situation where we have a lot of different interest groups competing over a large piece of tax legislation, each one concerned about the consequences of their particular tax provision. If theirs is left out and everybody else's is left in, that clearly has to be a concern; but that process is exactly how we got into the mess we are in now. And it has resulted in a lot of complexity, a lot of misallocation of capital, a loss of revenue, and high tax rates on what little bit of income we still wind up taxing after this process is over.

Venture capitalists would be in the best possible position if they were competing on the basis of what they have to sell to attract investment.

Chairman LAFALCE. Suppose we did want to give assistance to venture capital, do you share my perspective? Do you think that we could devise a more efficient method?

Mr. MINARIK. I would be very concerned on the tax side, Mr. Chairman, apart from the question of treatment of losses. I think it is very difficult to draw a fence around the area that you want to benefit.

Chairman LAFALCE. I don't think you could devise a perfectly efficient system, but it would seem to me that you could devise a system that would be more efficient in targeting venture capital than the present system.

Mr. MINARIK. I would guess to the extent that what we are talking about here is high technology processes—I may be causing some people to choke downtown, but we have a National Science Foundation which funds R&D in a lot of areas. It seems to me that we would be better off to the extent that we decided that technology in particular areas was terribly important, to the extent we decide that advances in that technology benefits society, in general, and might not be captured completely by the inventors and the engineers involved that we use the outlay side of the budget.

If you think about the amount of money that might be mistargeted through that process and compare it to the amount of money we lose through the exclusion of capital gains on sales of antique chairs and paintings and rugs and all that other stuff, I would much rather do it on the outlay side of the budget myself.

Chairman LAFALCE. I introduced a bill creating an Advanced Technology Foundation to do that precisely.

Mr. ACKERMAN. The whole dynamic of this economy is driven by the small company, and not necessarily high technology only. Approximately 50 percent of the jobs in this country are created by companies with less than 100 employees, and another 30 percent by companies with 100 to 1,000 employees, and only 20 percent are created by companies with over 1,000 employees. And that is biased at the low end.

Chairman LAFALCE. That is why we have a graduated corporate tax.

Mr. **Ackerman**. Yes, very important because those companies fund themselves to a large extent through retained earnings, but they need outside capital. The "Fortune 1000" list has had no net job creation in the aggregate in the last decade.

Chairman **LaFalce**. Aren't you making the point Mr. Minarik is making rather than refuting it? Aren't you giving capital gains rates to all the Fortune 1000 companies, to give assistance to venture capital?

Mr. **Ackerman**. No, because even in that list, there are growing companies and they have to go to the capital market.

You have already taxed the increase in value once by taxing corporate profits, because that is how the book value of a company goes up, with retained earnings after taxes have been paid. We have an entrepreneural economy that gives vibrancy and people take risks for the returns. And it is not good public policy to take the capital base of this country, tax it away and consume it through Government activity.

It is better for the country to leave that capital at work to create jobs, to create the payoff. The data we have from our data base in venture economics is that for the capital that is left in these venture companies, the rate of return to the Government in the form of capital gains, or—I'm sorry, corporate income taxes, payroll taxes and social security taxes is in the 20 to 30 percent per year. That is a very handsome return to the Government.

My other point, the total tax revenue from capital gains on corporate equities, runs less than 1 percent of the total Government revenues. So we are focused here on a very, very small sector of the revenue side. And we are focused here on the absolutely most crucial sector from the economic side in terms of job creation and innovation. And it seems to me that the balance of public policy is to encourage that side that creates jobs, creates innovation, that creates new products and useful technologies.

Chairman **LaFalce**. Mr. Ackerman, don't you think that indexing of your capital gains might create as low an effective tax rate on capital gains as preferential treatment?

Mr. **Ackerman**. Indexing favors the old established wealth over the new. If you index and you are a conservative investor because you have lots of wealth, you make out with indexing better than you do with the capital gains exclusion. The crossover is 5 or 6 percentage points return over the rate of inflation.

If you are a risk taker, then indexing is worse than the present system. So although Treasury I was revenue neutral on the capital gains side, it penalized the risk taker and rewards the nonrisk taker. Treasury I had the effect, for example, of lowering the tax rate on secure income investments by 30 percent and increasing the tax rate on risk investments by 75 percent. And it reduced, then, the risk premium so it made sense to put your money into tax exempts or utility bonds.

Chairman **LaFalce**. Mr. McLure, how much do you figure that Treasury would lose or gain because of the present capital gains tax treatment?

Mr. **McLure**. Let me try to answer you.

Chairman **LaFalce**. Then I want you to give me the numbers under Treasury I, and then under Reagan I.

Mr. McLURE. Let me try to answer fairly specifically. I think it is imporant to talk about the effects of fairly small changes around the range where we are now, because clearly, as you talk about moving toward full taxation as ordinary income, or as you move toward total exclusion of capital gains entirely, you get different results. The studies we have done indicate that by the time you take account of the effects of the greater realizations that would occur because of lower capital gains taxes, there probably is not a great deal of revenue impact one way or the other.

That result is for relatively minor changes around where we are now. Clearly if you move away from that, you will start seeing bigger changes. In other words, we are saying that our estimates are that the net revenue effect, say, of changing the effective tax rate from 20 to 17½ percent would not be much.

Mr. MINARIK. Mr. Chairman, one thing that has to be kept in mind here is that there is a kind of a stock flow problem in looking at realizations of capital gains. When we had the big cut in capital gains taxes in 1978, there is a fair amount of evidence that on a one-time basis we brought a lot of appreciated assets out of the woodwork.

The tax rates came down fairly substantially, and there were a fair number of people who decided that at 28 percent instead of 35 percent or in some cases up higher than that, that what the heck, they would cash in their gains and put the money in other places that in the future they thought might yield a better return.

The problem is when you do that once, and you clean out the closet of a lot of these appreciated assets, that appreciation in the hands of current investors is not there the next time you go back to the closet. So in 1981, when effective June 9, if memory serves me, the top capital gains rate was reduced from 28 to 20 percent, there was less of a boom of realizations, and that may very well have been just because the stock was somewhat depleted from before.

When you try to do it a third time, you would expect to have less of a short-term increase in realizations still than you did the first two. On the other hand, we have had a lot of upward movement in the stock market. In 1982 we had a banner year on the market. There hasn't been a lot of action this year. That helps to replenish the closet of accumulated appreciation.

We have to be careful about saying any given change in the capital gains tax rates is going to encourage more realizations, and therefore, pay for itself, even in the short run.

Chairman LAFALCE. We have to be careful with any arguments that say they are going to pay for themselves.

Mr. McLURE. I should clarify that Joe is obviously correct; that you shouldn't look at the one-time blip that occurs because of reducing the rates. What I was dealing with was——

Chairman LAFALCE. You had an unbelievable blip after 1978.

Mr. McLURE. I was dealing with the long run effect, and there again, based on the study done at the Treasury Department, it appears that the longrun effect of the 1978 capital gains tax reductions was to increase revenues rather than to decrease them. The evidence on the 1981 cut is somewhat less clear, and we are still looking at that evidence. Clearly you would eventually have to get to a point where a tax cut would reduce revenues.

Mr. MINARIK. Part of the reason is, as the tax rate goes down, your increase in what you pocket after you sell the asset goes down as well. If you cut the tax rate from 50 to 28 percent, you are, in effect, increasing what the person gets to keep after he sells the asset by half. You go from 28 to 20 and you are increasing it from 72 to 80 percent. So there you are only increasing it by one-ninth.

The change in the after-tax profit of selling capital assets is really pretty small, so you would expect to get a much bigger boom the first time you cut it, and as the rate gets lower, there is less of a bonus there for the seller.

Mr. ACKERMAN. The lock-in effect is very real, and we, during the seventies, found it very difficult to justify selling something and giving the Government 50 cents on the dollar, and then going back and reinvesting the remaining 50 cents in a new company.

The effect is the tax rate changed our activity level very dramatically so that the numbers of transactions we are doing today is higher by a factor of 5 or 6 times.

Chairman LAFALCE. I remember the change in 1978. Wasn't your primary advocacy for indexation?

Mr. ACKERMAN. No, the venture capital industry has never advocated indexing.

Chairman LAFALCE. The change was basically the Steiger amendment, but Steiger also offered an amendment before that that would have indexed capital gains without the change in the rate.

Mr. ACKERMAN. Indexing is not particularly helpful to venture investing; because of the nature of venture investing, you have a few that are enormously successful, a lot that are sort of moderate or in the living dead, which you can't figure out what to do with, and a few you lose entirely.

Chairman LAFALCE. Other than the national——

Mr. ACKERMAN. Excuse me.

Chairman LAFALCE. Maybe it was individuals interested in the capital gains tax rate other than the venture capital lists?

Mr. ACKERMAN. A large part of the capital gains are from other things, real estate, for example, and I don't speak to the wisdom of that. For corporate securities, the lock-in effect, was enormous, and the willingness to sell and reinvest was greatly reduced by the high rates and the problem we saw with Treasury I, 35-percent rate on capital gains at the Federal level, and then as high as 14-percent rate at State and local levels.

We were back to the 50-percent level, and it would have had exactly the same effect on our activity levels. Now, the Government does not really realize the benefit of our activity levels until 5 to 10 years after we increase those activity levels, because it takes that long for a venture-backed company to become a good, solid viable company and create the kinds of values so that you would want to sell the stock.

So where we are right now, today, is in the middle of that process. An enormous amount of money has been put out into companies to start them, and if there is no money available in the public markets over the next few years for them, we will lose those investments and lose the support of the institutional investors that put up the original money. And we would be a long time recovering from a mistake if we make a tax policy mistake here that causes our public market to decline and the amount of capital available to these young companies to decline.

We have not yet seen the significant benefits of the explosion in venture capital that has taken place over the last few years. That will come in the next 5 to 10 years, and it is quite dramatic because there are a lot of good young companies out there. But we can kill them off if we don't follow an intelligent tax policy.

Chairman LaFalce. We have made all our comparisons thus far using Treasury I, the Reagan proposal, current law.

Mr. Minarik, you probably were the principal architect of the Bradley-Gephardt bill. Having the advantage now of Treasury I and the Reagan proposal and criticism, comments, et cetera, not just viewing this provision, but the totality of the tax company, what changes would you envision in, say, Bradley-Gephardt?

Mr. Minarik. Well, Mr. Chairman, Bradley-Gephardt was written under a number of constraints, and among them were, No. 1, not redistributing the tax burden within the household sector at all; and, No. 2, not redistributing the tax burden between the corporate and individual sectors at all. The reason for making those choices was that if you go back to late 1981 and early 1982, anybody who came out for tax reform at that time was viewed, I guess, kind of like somebody 35 years ago who parked in front of his house a funny looking German car that was shaped like an insect, and the idea was to raise as few hackles as possible about issues that were considered to be incidental to the overall concept.

Having gotten past that, there are some things that the administration did in Treasury I that I think were well taken. One was the increase in corporate taxes to finance a household sector tax cut. That was discussed in the course of putting together Bradley-Gephardt, but it was discarded, because it was thought that would simply create a diversion. In addition, it is clear if you are going to give a tax cut within the household sector, that taxpayers at low and moderate income levels deserve a greater share of it, for the reason that if you go back 10 or 15 years, you discover that those taxpayers have suffered fairly badly from the erosion of the personal exemptions and the standard deductions because of inflation.

And the 1981 tax cut didn't deal with that at all. It simply cut rates, and that meant that a taxpayer at a moderate income level who was inflated on to the tax rolls from the mid 1980's got a 23-percent tax cut, whereas if you were going to make him whole for the effective inflation, you should have given him a 100-percent tax cut so that he would be made whole.

Chairman LaFalce. Therefore, you would increase the personal exemption and zero bracket them?

Mr. Minarik. We did, but not to the extent that the tax burden was redistributed. The net effect of the base broadening was exactly offsetting in any income group. You would want to go a little bit further than that, along the lines that have been done in both Treasury I and the Reagan plan. Beyond that, really what is left is a question of competing resources, and a reduction in capital gains tax rates is good for some sectors, but it might be wasted in terms of dealing with other sectors, or some people believe that that is the case, and so that was resisted.

And it would probably continue to be resisted. In terms of indexation of capital gains which was not done under Bradley-Gephardt, it was to a large extent a question of trading off the benefit of more neutral taxation of capital gains against the complexity that it would cause and the higher statutory rates that would be necessary.

The same is true of the kind of proposal that the administration put forward in the dividends paid deduction which from the point of view of an economist is unquestionably a good thing. I think we concluded fairly early on in the process that that kind of a proposal would not survive, because, in effect, it pits some investors against corporate managers, where investors want better tax treatment of dividends because they want more dividends to be paid, and corporate managers want to hang on to their earnings so they can reinvest them for their own purposes.

And those of us who remember back to 1978 and the plan the Carter administration floated, have fairly vivid impressions of the extent to which a partial scheme of that sort can create a great deal of devisiveness within the investment and corporate communities.

We thought about an integration proposal of that sort and came to the conclusion that it would not add anything to the package politically and would be another diversion, so we left it out. I would have to say that given what the administration has done between Treasury I and the Reagan plan, that that judgment has been pretty well borne out; and to the extent that I catch vibrations from this part of town, I get the impression that the 10-percent dividends paid deductions is not going to last through the legislative process. I may be wrong, but that would be my guess.

So I guess I don't have any tremendous ideas about what I would do, except to some extent to raise somewhat more money in the corporate sector, provide a tax cut across the household sector pretty much a la Treasury I, and at that point I would continue to be fairly satisifed.

Chairman LAFALCE. I am taking advantage of your presence to discuss issues now other than venture capital just for about 5 minutes or so. One is more common than anything else. As I view the Reagan proposal, Mr. McLure, it is a combination of good and bad features in my judgment. One of the most inequitable things you have done is, if you assume that there is validity in taxing fringe benefits, to tax the lowest possible base of fringe benefits and then say, anything above and beyond that shall be excluded. It may well have been a political decision, but it really is one of the most inequitable judgments that was made.

You probably hope that it is changed by the committee more so than anybody else. If that is your hope, we join with you. I just wish the President had not put it in his own proposal. You don't even have to comment. Mr. Minarik?

Mr. MINARIK. If I might just add for the edification of the subcommittee, a fellow I talked to a couple of weeks ago came up with a line that the administration's handling of fringe benefits belongs in Doonesbury. I think that says it all.

Chairman LAFALCE. It is unbelievable.

Let me ask another question now, both of Mr. McLure and Mr. Minarik, if either of you has thought about it and would wish to comment.

What concerns me is that no one in considering tax reform has viewed or considered the totality of Federal taxation. They have only considered the income tax, both personal and corporate, and perhaps the most regressive of our Federal taxes is the Social Security payroll tax. Perhaps more American taxpayers pay more of their total Federal tax burden in Social Security payroll taxes than in income taxes. And it has probably had more to do with an inequitable distribution of societal resources in the past decade than any other provision of the Tax Code or any other outlay. Have either of you given thought to including the reform of the Social Security payroll tax, perhaps starting out with funding disability and Medicare benefits from general revenues rather than from the payroll tax? If you have not given much thought to it, is there anyone in academia who has given thought to it and fleshed those ideas out?

Mr. McLURE. Let me answer part of the question, and perhaps defer the last part to Joe.

I would just say in putting together Treasury I——

Chairman LAFALCE. I mean do you think that this is of as much significance as I do?

Mr. McLURE. I would say no in the sense that unlike most taxes, we shouldn't look at Social Security taxes independently of the benefit side because, while Social Security taxes are regressive, the benefit structure of Social Security payments is clearly pro-poor. And if you put together the taxes and the benefits, the entire Social Security system is going to favor the poor rather than being disadvantageous to them. So it is not appropriate to treat Social Security taxes by themselves and focus on their regressivity.

Now, leaving that aside, I will finish by saying that in Treasury I we considered whether or not to address Social Security, decided that since the expenditure side and taxes are inevitably interrelated, and since Social Security had fairly recently been the subject of a major compromise, it did not seem sensible to take that on again in the context of tax reform.

Mr. MINARIK. Let me echo Charlie's first point which is very important. I think the extent to which we think of Social Security now as being very inequitable probably has a lot to do with the fact that the whole program has become much more expensive over time. When we had a payroll tax at 5.35 percent on employers and employees with a relatively high base, you could slough it off and not worry too much about the short-term cash impacts on low income people because they are going to get a better rate of return later on.

Now that the tax rates are approaching 8 percent each, it sure looks a lot worse.

Chairman LAFALCE. What is the capital now, 37, 38?

Mr. MINARIK. Almost 40,000. The complication is that we have kind of eased into this situation where this cash burden on low income people is a lot larger, and if we knew we were going to get there, we might have earlier on tried to get around the insurance analogy somewhat. Now if you want to do that, it is somewhat more difficult because you have got a system that has problems.

The glib answer to a lot of questions like this—Willie Sutton said he robbed banks because that is where the money is. You might as well say that is the reason why you go after the income tax. That is becoming less and less an accurate statement.

Chairman **LaFalce**. The payroll tax is financing the deficit right now.

Mr. **Minarik**. One of the points you raise, Mr. Chairman, is much to the point, if you look at the insurance analogy. The Medicare Program fits in a lot less neatly with the insurance analogy than does OSAI or even DI. Medicare is a lot trickier, and now, it seems to me that probably the first thing that has to be done is some action on the outlay side as far as medicare is concerned. And I am far from an expert there, but over recent years we have had an explosion on the outlay side and part of the problem of taking that and putting it into the general fund might very well be that you suddenly have got a time bomb in the general fund instead of in the Social Security system.

Chairman **LaFalce**. Can both of you find out if anybody has given thought to this issue and come up with any proposals along the lines I suggested, and contact me directly if you want or staff.

[In response to the request of Chairman LaFalce, the following information was received for inclusion in the record:]

THE URBAN INSTITUTE
2100 M STREET, N.W. / WASHINGTON, D.C. 20037 / (202) 833-7200

June 26, 1985

Representative John J. LaFalce
Subcommittee on Economic Stabilization
House Committee on Banking, Finance,
and Urban Affairs
2220 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative LaFalce:

This is in response to your question during the hearing of the Subcommittee on Economic Stabilization on June 19, 1985, concerning research on the funding of medicare and disability insurance through the social security payroll tax.

There has been more interest in medicare than disability insurance funding in recent years. Interest in medicare, however, has focused more on injections of general revenues into the medicare trust fund than in extraction of medicare from the social security system with complete funding from general revenues. The reason is a fear that complete general revenue funding would lead to means testing of medicare benefits.

New sources of revenue considered for medicare funding include shares from the income taxes, the alcohol and tobacco excise taxes, and the estate tax (with the last of these tied in some way to benefits received during life). Dicussions of some of these options are included in a print of the Subcommittee on Health of the Ways and Means Committee entitled Proceedings of the Conference on the Future of Medicare, dated February 1, 1984. Two papers from this conference are especially pertinent, one written by Karen Davis and Diane Rowland, and another by Stephen H. Long and Timothy M. Smeeding.

I hope that this information is helpful. I will be happy to cooperate in any way I can if you wish to pursue this inquiry further.

Sincerely,

Joseph J. Minarik
Senior Research Associate

Chairman **LaFalce**. One last question, off the subject again, aside from the politics of it, why in God's name if we needed to raise moneys and we do, and want equity, and we do, why haven't we proposed in either—I don't now about Bradley-Gephardt, but in Treasury I or the Reagan proposal—to tax Social Security benefits, if we are going to tax unemployment compensation benefits. What is the rationale for excluding, at least half of Social Security benefits in any event? I understand the first half.

Mr. **McLure**. I will let Joe respond for Bradley-Gephardt.

Chairman **LaFalce**. Aside from politics.

Mr. **McLure**. Again, we simply felt that we had just been through a long discussion of Social Security, so perhaps there is no reason not to examine this issue aside from political considerations.

Chairman **LaFalce**. Can we say there is no good reason apart from political?

Mr. **Minarik**. If you tax Social Security like a pension, the taxpayer would get to take a deduction for the Social Security taxes that he paid out of his after tax income so that that much he would be able to recover.

Chairman **LaFalce**. I have no quarrel with that.

Mr. **Minarik**. So the reason why the half figure comes up is because the employee pays half the tax. That, in fact, ignores the fact if it were a pension system there would be earnings on that half, so really the employee would only be able to take a deduction for less than half.

Chairman **LaFalce**. Some have advocated going to 40 percent or so.

Rather than arguing about when you should not have a cost-of-living increase for Social Security benefits, where you clearly are going to hit those below the poverty line, you could raise vastly greater sums of money without affecting those near the poverty line by taxing approximately 50 percent of all their benefits and let the progressivity of the income tax code hold those immune who must be held immune, and tax those who can afford to be taxed.

Mr. **Minarik**. I would certainly buy that, Mr. Chairman. The complication of going after Social Security right now is in part political and I really feel I have to point this out. To the extent that you were to take those people who are now paying tax on their Social Security benefits and make them pay more, you would be edging toward the line where the tax treatment of Social Security would become less generous than that of a private pension that provides the same benefits after the same contributions out of after tax income.

One thing you would not want to do——

Chairman **LaFalce**. Well, you could deal with that, though.

Mr. **Minarik**. Sure you could. If you don't want to have that kind of a problem, tax half of everybody's benefits, because you know that at that point you are being more generous than you would need to be.

Chairman **LaFalce**. Or reduce the 25,000, 32,000 to 25, 20, 15?

Mr. **Minarik**. There you have the perception that you are leaving the fat cats alone and going after the relatively littler people. To the extent it could be done in the context of tax reform, personal exemptions are increased and the rates are reduced, you might be able to finesse it by saying you are giving more than you are getting, but it would be a finesse on the political side that you have to pull off.

Chairman **LaFalce**. Theories on numbers—you still retain your 50-percent exclusion—how much would that raise in 1 year, ball park?

Mr. **McLure**. I could get an estimate, but I don't have one with me.

Chairman **LaFalce**. Would you provide me with some type of estimate? That would be interesting.

[The responses to questions by Chairman LaFalce follow:]

Requested Responses to Questions from Representative LaFalce

Chairman, Subcommittee on Economic Stabilization

Committee on Banking, Finance and Urban Affairs

1. Question: When was the $3,000 limit on the deductibility of capital losses first established?

   Answer: The $3,000 limit has been in effect since 1978; the limit was $1,000 from 1955 to 1976, and $2,000 in 1977.

2. Question: Are there any academic studies on reform of the social security payroll tax, including funding disability and Medicare benefits from general revenues?

   Answer: There are many such studies, including: (a) Henry Aaron, Economic Effects of Social Security, Brookings Institution, 1982; (b) Michael Boskin (ed.), The Crisis in Social Security: Problems and Prospects, Institute for Contemporary Studies, 1978; (c) Martha Derthick (ed.), Policy Making for Social Security, Brookings Institution, 1979; (d) Rita Ricardo Campbell, Social Security: Promises and Reality, Hoover Institution, 1977; (e) Alicia Munnell, The Future of Social Security, Brookings Institution, 1977; (f) Rudolph Penner, Social Security Financing Proposals, American Enterprise Institute, 1977; (g) Felicity Skidmore (ed.), Social Security Financing, MIT Press, 1981.

3. Question: How much revenue would be raised by continuing the exclusion of 50 percent of Social Security benefits, but lowering or eliminating the current $25,000/$32,000 (single/joint returns) thresholds?

   Answer: Eliminating the thresholds would increase revenues by $6.18 billion in 1986. Lowering the thresholds to $20,000/$25,000 would increase revenues by $0.97 billion, while lowering them to $15,000/$20,000 would increase revenues by $2.00 billion. For purposes of comparison, the taxation of Social Security benefits under current law would raise revenues of $3.86 billion in 1986.

Chairman **LaFalce**. Gentlemen, I want to thank you very, very much. It has been extremely interesting, and I personally appreciate your testimony today.

[Whereupon, at 12:05 p.m., the subcommittee was adjourned subject to the call of the Chair.]

[The statement of the American Electronics Association was submitted for inclusion in the record:]

Statement of the American Electronics Association

submitted to
Subcommittee on Economic Stablization
Committee on Banking, Finance and Urban Affairs

Hearing on the Impact of Tax Reform on Venture Capital

Wednesday, June 19, 1985

Mr. Chairman, The American Electronics Association appreciates the opportunity to contribute to your hearing on the impact of tax reform on venture capital.

Description of AEA

The American Electronics Association is the largest trade association of this nation's largest manufacturing industry. AEA represents over 2,500 member companies nationwide, and over 450 financial, legal and accounting organizations which participate as associate members. AEA encompasses all segments of the electronics industries including manufacturers and suppliers of computers and peripherals, semiconductors and other components, defense systems and products, telecommunications equipment, instruments, software, research, and office systems. The AEA membership includes companies of all sizes from "start-ups" to the largest companies in the industry, but the largest number (71%) are small companies employing fewer than 250 employees. Together our companies account for 63% of the worldwide sales of the U.S.-based electronics industries.

AEA American Electronics Association
1612 K Street, N.W., Washington, D.C. 20006

The Importance of High Technology to the U.S. Economy

A recent Commerce Department study concluded that:

> "High technology industries are vital to the U.S. economy. Their growth rate has been twice that of total industrial output, and they contribute the bulk of technological advances to all sectors of the economy.
>
> "National security depends upon the technology-intensive industries both for sophisticated items essential to modern weapons superiority, and for a strong and flexible industrial capacity for future contingencies.
>
> "The United States will have to depend heavily on its areas of greatest strengh -- principally advanced technology -- to meet increased competition in world markets." 1/

Vital as these electronics companies are for thei contributions to innovations, productivity, national security and our quality of life, two important facts about them are not widely recognized.

First, as a direct result of the enlighted capital gains policies of the last seven years **the U.S. electronics industry has created over a million new domestic jobs and become the nation's largest manufacturing industry, now employing over 2.6 million Americans.** Policies which impact this industry therefore have an immediate and substantial impact on this nation's manufacturing sector and its overall economy.

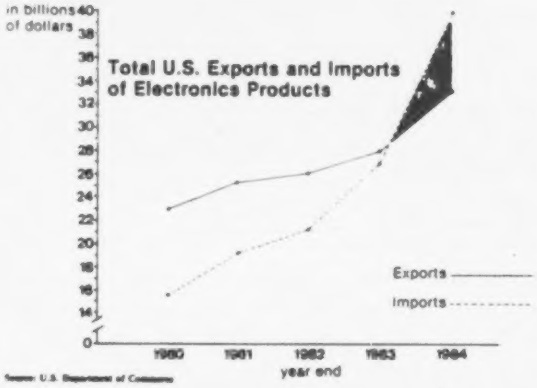
1/ An Assessment of U.S. Competitiveness in High Technology Industries; International Trade Administration; U.S. Department of Commerce; February 1983; pg. iii.

over a million new domestic jobs and become the nation's largest manufacturing industry, now employing over 2.6 million Americans. Policies which impact this industry therefore have an immediate and substantial impact on this nation's manufacturing sector and its overall economy.

Second, **the future of this industry, and these jobs is now in jeopardy due to a decline in the international competitiveness of our technology industries.** As noted in the recently released Report of the President's Commission on Industrial Competitiveness, U.S. companies have lost world market share in seven out of ten high technology sectors in the last 20 years. 2/

As a result of this loss of market share the surplus which these companies have traditionally contributed to the nation's trade balance became a serious trade deficit in 1984.

The United States world-wide trade in electronics products has fallen from a surplus of $7.4 billion in 1980 to a deficit of $6.2 billion in 1984.



Source: U.S. Department of Commerce

2/ Global Competition, The New Reality; Report of the President's Commission On Industrial Competitiveness (Young Commission); January, 1985; pg. 16.

With that background, we would now like to turn to the specific issues before this Committee.

The Importance of Retaining the Capital Gains Differential

This nation's vital high technology sector is unusually vulnerable to increases in the tax on capital gains. To succeed in their intensively competitive markets, high technology companies need to grow at a faster rate than they can finance through retention of their own earnings. Even though they typically pay minimal or no dividends, they must frequently seek new infusions of outside risk capital investment.

The investors who provide this capital know they will receive no significant dividends. They can only hope for capital appreciation. This makes their investment decisions extremely sensitive to fluctuations in the tax on capital gains. History has shown when taxes on capital gains go up, these investors lose interest in risky, high technology ventures. When they go down, these investments and the economy at large flourish.

Lessons from History

In the last 15 years, our nation has experienced two dramatic demonstrations of the damage and benefits that changes in the taxation of capital can cause.

The Tax Reform Act of 1969, together with its subsequent revisions, raised the maximum effective tax on capital gains from 25% to 49%, and reduced the write-off to capital losses by 50%. All in all, the rewards for success were cut in half, and the penalties for failure were doubled. The effect on venture capital was devastating. The ability of small companies to raise equity capital by public stock issues declined drastically, and by 1973 small company issues had practically ceased.

A 1978 American Electronics Association survey documented that during 1971-75, companies in the electronics industry were able to raise less capital in real terms than at any time in the prior fifteen-year period. 3/ This scarcity of investment funds caused many technology companies to stop growing, go deeply in debt, or sell their valuable technologies to foreign competitors in Europe or Japan just to meet their payrolls.

The Turning Point

Then in 1978, the late Congressman William Steiger and several current members of the Ways & Means Committee proposed reducing the effective tax on capital gains from 49% to 28%. They argued that allowing people to keep more of their capital gains would encourage investment and create jobs. Their proposal was ridiculed at the time as a "millionaires' relief act", which the Treasury estimated would cause a net revenue loss of $2.2 billion per year.

Rejecting that argument, Congress lowered the capital gains tax, and our nation's entrepreneurial revival began.

Results of the 1978 and 1981 Capital Gains Tax Reductions

Mr. Chairman the results of the 1978 and 1981 capital gains tax reductions have been spectacular:

1. The first and most immediate response was a boom in the amount of venture capital that became available for investment in "start-ups" and young company growth.

2. This capital led to a burst of entrepreneurship and new company creation which has caused dramatic growth in the electronics industry's employment.

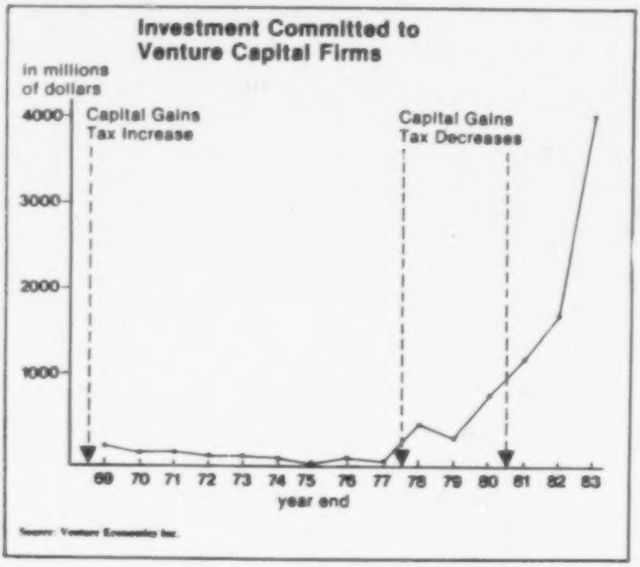
3/ Testimony before the House Ways and Means Committee by Edwin V.W. Zschau on behalf of the American Electronics Association, March 7, 1978.

3. At the same time, the Treasury's static predictions of revenue losses were contradicted by major **increases** in capital gains collections at the lower rates.

We will briefly describe each of these effects.

Effect on Venture Capital

As the following chart clearly demonstrates, the 1978 capital gains reduction triggered a major increase in the amount of money invested in organized venture capital funds. According to Venture Economics, Inc, of Wellesley Hills, Massachusetts, such investments increased from $39 million in 1977 to $4.2 billion in 1984. (See Appendix I). The total pool of venture capital in this country increased from approximately $3 billion in 1977 to $16.3 billion in 1984.


Investment Committed to Venture Capital Firms

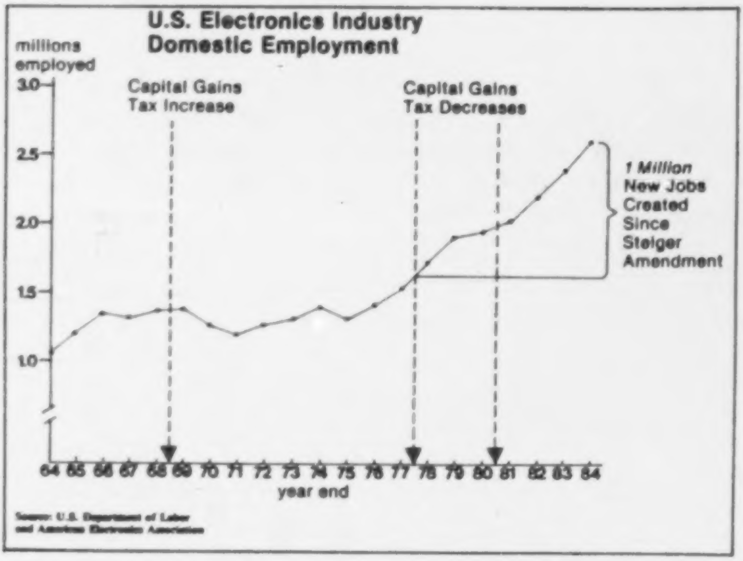
Source: Venture Economics Inc.

Effect on Electronics Industry Employment

Nearly all of the venture capital invested in this country goes into "start-up" or emerging young companies. These are the same companies which generate the most new jobs for the economy.

It's important to realize however that lower capital gains taxes have greatly improved the ability of companies of all sizes to raise the risk capital they must have to grow. For example public companies with a net worth of less than $5 million raised only $75 million in 1977. By 1983 these companies were raising $3.7 billion. Even in the relatively depressed market of 1984 they raised $1.2 billion. (see Appendix I)

As a direct result of this increased capital availability the U.S. electronics industry has created over a million new domestic manufacturing jobs since the captial gains tax reductions of 1978.



U.S. Electronics Industry
Domestic Employment

Source: U.S. Department of Labor and American Electronics Association

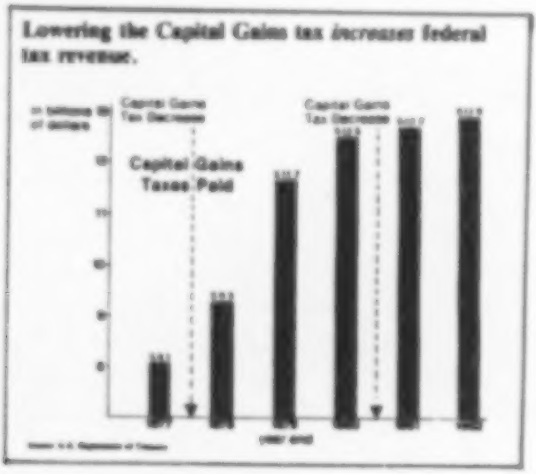
To put this million job statistic into perspective, it is useful to compare it with another important industry. According to the American Iron and Steel Institute, the total employment for that industry at the end of 1984 was 236 thousand jobs. This means the electronics industry has added the employment equivalent of more than four entire steel industries just since 1978.

During the period of high capital gains tax rates (from 1969 to mid 1978), the electronics industry added an average of 25,000 jobs per year. After the capital gains reduction, the industry averaged 150,000 new jobs per year. Thus lower capital gains taxes contributed to the creation of an additional 125,000 jobs per year in the electronics industry alone.

We do not contend the capital gains changes were the only factor which caused this increase in employment. But we are convinced that without the lower capital gains rates our industry could not have generated adequate capital to finance this level of growth.

Effect on Federal Revenue

A final, but crucial point to understand is that **reducing the capital gains tax does not cost the Treasury revenue--it actually increases capital gains tax collections.** Despite official predictions of a $2.2 billion revenue loss if the Steiger Amendment passed, Treasury's receipts increased from $8.1 billion in 1977 to $11.7 billion in 1979. As the following chart illustrates, the same effect was repeated in 1981. When the tax rate came down, Treasury's capital gains revenue went up.



The "Golden Egg" of Tax Policy

The point we want to emphasize is that this is a tax provision that earns its keep. **If there can be said to be a "golden egg" in tax policy, this is it. The capital gains tax differential is a powerful engine of job creation which also generates positive revenue for the Treasury.**

Rebutting the Critics

But since we are discussing tax policy, no matter what the benefits to the economy as a whole, there will always be controversy over provisions which benefit high income taxpayers. You have already heard testimony today that the capital gains reductions aren't really the reason that venture capital boomed and therefore the job creation we cite has to have been caused by other factors. For example, on June 7, 1985 Mr. Robert S. McIntyre, Director of Federal Tax Policy for an organization called "Citizens for Tax Justice" testified before the House Ways and Means Committee that the vast majority of the funds invested in venture capital come from tax exempt or extremely low-taxed entities for whom the incentive has no importance. He said "Only 13 percent of the increase in venture money from 1978 to 1984 came from individual investors, the people affected by the capital gains tax cuts."

This statement is factually incorrect. It is based on a faulty understanding of the data collected by Venture Economics, Inc. Mr. Stanley E. Pratt, Chairman of that firm recently wrote Treasury Secretary Baker to correct the record. Mr. Pratt's letter states in part: "Tax-exempt (pension, foreign, endowment and foundation) investors are not the principal source of funding for venture capital funds...The current capital committed to the organized venture capital industry is approximately $16 billion of which at least 62% is from taxable sources and only 38% from tax-exempt investors".

But this 38% still only relates to the organized, formal venture capital industry as such. It does not count the large amount of risk capital investments made by private individuals who are not considered professional venture capitalists. Essentially all of these investors are affected by changes in the capital gains tax.

Mr. Pratt explains that "potential opportunity, not tax consideration, stimulates institutional investment. Innovators perceiving a favorable environment will create investment opportunities and institutional capital investment will flow towards the proven successes." In other words, it is because of the efforts of tax-motivated entrepreneurs that these investment opportunities have attracted institutional support. (The complete text of Mr. Pratt's letter is attached to this statement as Appendix II.)

J.E.C. study confirms importance of the Capital Gains Differential

A major study of the venture capital industry conducted by the Congressional Joint Economic Committee independently confirmed Mr. Pratt's finding that the vast majority of venture capital comes from tax paying sources. 4/ The J.E.C. conducted the largest survey of the venture capital industry ever performed, and they did it in 1983-84, before the first Treasury reform proposal was released. Two hundred seventy-seven venture firms of various sizes responded.

The Joint Economic Committee concluded that: "The capital gains tax differential was, and continues to be, a major factor behind the post 1978 surge in venture capital availability". 5/

The last comparative advantage

Mr. Chairman, in concluding our comments on this subject, I want to return briefly to the vital question of America's competitiveness in international trade. There is wide agreement

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4/ "Venture Capital and Innovation"; Joint Economic Committee; S. Prt.98-288; December 28, 1984; pages 20, 21.

5/ J.E.C. ibid. Pg. XI

that the economic future of this nation depends on the ability of U.S. companies to compete with foreign goods in world markets and at home. As you know, U.S. exporters are fighting against severe handicaps. Our cost of capital is higher than our foreign competitors'. Our cost of labor is much higher. The cost of our materials is often higher. The overvalued dollar then amplifies the impact each of these other factors.

But the United States does have one remaining comparative advantage over our foreign trading partners. It is our nation's spirit of entrepreneurship and innovation. This spirit is the envy of competitors. It is our nation's best hope for the future. And, it is driven by a quest for capital gains.

Mr. Chairman, we simply cannot afford to quench that spirit by reducing the capital gains tax differential.

VENTURE ECONOMICS

Appendix I

VENTURE CAPITAL INDUSTRY
ESTIMATED
FUNDINGS AND DISBURSEMENTS
(Millions of Dollars)

Year	Net New Private Capital Committed to Venture Capital Firms*		Size of Total Pool	Estimated Disbursements to Portfolio Companies		Public Underwritings of Companies with a Net Worth of $5 Million or Less	
						Number	Amount
1984	$4,200	$13,400	$16,300	$3,000	$11,650	(224)	$1,186
1983	4,500		12,100	2,800		(477)	3,671
1982	1,800		7,600	1,800		(113)	619
1981	1,300		5,800	1,400		(306)	1,760
1980	700		4,500	1,100		(135)	822
1979	300		3,800	1,000		(46)	183
1978	600		3,500	550		(21)	129

Capital Gains Tax Decrease

1977	39	$466	2,500-3,000	400	$2,935	(22)	75
1976	50			300		(29)	145
1975	10			250		(4)	16
1974	57			350		(9)	16
1973	56			450		(69)	160
1972	62			425		(409)	896
1971	95			410		(248)	551
1970	97		2,500-3,000	350		(198)	375

Capital Gains Tax Increase

1969	171		2,500-3,000	450		(698)	1,367

Total Estimated Capital Committed to the Organized Venture Capital Industry
(Billions of Dollars)

	12/31/82	12/31/83	12/31/84
Independent Private Venture Capital Firms	$4.4	$ 8.2	$11.8
Small Business Investment Companies	1.3	1.4	1.6
Corporate Subsidiaries (Financial and Non-Financial)	1.9	2.5	2.9
Total	$7.6	$12.1	$16.3

This pool remained static from 1969 through 1977 at some $2.5 to $3.0 billion (with new fundings more or less equal to withdrawals).

*Total new private capital less capital withdrawals.

SOURCE: Venture Economics, Inc.

Venture Economics, Inc.
16 Laurel Ave., P.O. Box 348, Wellesley Hills, MA 02181
(617) 431-8100 Telex: 94-8637 VENTICON WELL

Appendix II

VENTURE
ECONOMICS

April 5, 1985

The Honorable James A. Baker III
Secretary of the Treasury
Department of Treasury
15th and Pennsylvania Avenue NW
Washington, D.C. 20220

Dear Mr. Baker:

There has recently been confusion in the national media as well as in data from the Treasury Department as to the role of non-taxable investors in the funding of the organized venture capital industry. Since Venture Economics, Inc. or our monthly publication, VENTURE CAPITAL JOURNAL, is credited as the information source, it is important that we inform you of the facts.

Tax-exempt (pension, foreign, endowment and foundation) investors are not the principal source of funding for venture capital funds. The confusion was most probably occasioned by analysis of only one of the segments of the venture capital industry, the independent private venture capital firms, but their $11.4 billion represents only 71% of the total industry capital. The other sectors, Small Business Investment Companies ($1.6 billion) and corporate subsidiaries ($3.0 billion) are almost exclusively taxable entities.

Analysis of the complete data shows that the increase in venture capital between 1978 and 1984 was slightly over $13 billion. Tax-exempt investors provided almost $5.4 billion of this total. The current capital committed to the organized venture capital industry is approximately $16 billion of which at least 62% is from taxable sources and only 38% from tax-exempt investors. If one considers informal venture investments from taxable individuals, which some analysts estimate to be greater than the organized activity, tax-exempt investors are even less significant.

Pension fund investors are important to the process since some portion of their more than $1 trillion of investment assets must be attracted to finance new business development. While they will not be directly influenced by tax considerations, they do in fact seek investment opportunities in favorable environments that have been stimulated by tax incentives. Even though many like to credit them with a leadership role, the fiduciary responsibilities of pension, endowment and foundation investors mandate a followers role in new investment trends, after others have served as pioneers.

Potential opportunity, not tax consideration, stimulates institutional investment. Innovators perceiving a favorable environment will create investment opportunities and institutional capital investment will flow towards the proven successes.

It is critical that we understand the real forces that drive new business development -- the perceptions of the entrepreneur. The belief that he or she will succeed in building a major new business and significant personal wealth despite the fact that most new businesses fail is a perception that often overcomes stark reality.

The favorable capital gains tax differential not only reinforces this perception, but it is critical in enabling the entrepreneur to attract the key employees who will leave large corporation comforts to work 80-hour weeks to make the vision a reality.

Incentives are relevant because entrepreneurs perceive them to be necessary. How can any of us ignore the sterility of new business development from 1969 through 1977, the period during which there was no differential between capital gains and ordinary income tax rates?

The rationale behind the current Treasury Department tax reform proposal overlooks two important factors. First, increasing the capital gains rate while decreasing the tax rate for dividends and interest income benefits the wealthy at the expense of those seeking to build wealth. In effect, we would hamper the most powerful instrument for social mobility in our economy -- not just for the Steve Jobs' (Apple Computer), but for the many hundreds of middle class employees who joined the effort and shared the success.

The capital gains tax differential can enable young businesses to compete with large corporations for both the capital and, by making Incentive Stock Option plans attractive, the management talent.

Second, our entrepreneurial climate and venture capital infrastructures are key competitive advantages internationally. The Europeans and Japanese recognize this and are attempting to develop a similar environment. Should we take an opposite course and signal entrepreneurial disfavor by eliminating the capital gains tax differential?

There has been discussion recently about providing special treatment for the venture capital industry. I strongly believe that narrowly targeted tax incentives are not feasible in the long term. Entrepreneurs, venture capitalists and investors should be rewarded for success, for achieving growth of jobs and economic benefits, for the creation of new wealth and value, not reimbursed for unsuccessful attempts. The capital gains tax differential rewards risk-taking and patience without undue targeting.

Very truly yours,

Stanley E. Pratt, Chairman
Publisher VENTURE CAPITAL JOURNAL

SEP/

cc: The Honorable Richard G. Darman
Deputy Secretary of the Treasury

The Honorable Ronald H. Pearlman
Assistant Secretary for Tax Policy